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Sep 13 2024

SC Court of Appeals

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc.,	)	Docket No. 21-ALJ-17-0182-CC
	)	
Petitioner,	)	
	)	ORDER GRANTING MOTION
v.	)	FOR RECONSIDERATION
	)	
South Carolina Department of Revenue,	)	
	)	
Respondent.	)	

This matter is before the South Carolina Administrative Law Court (Court) pursuant to a Motion for Reconsideration filed by CarMax Auto Superstores, Inc., (Petitioner or CarMax East). Petitioner moves this Court pursuant to Rule 29(D) of the Rules of Procedures for the Administrative Law Court (SCALC Rules) and Rule 59(e) of the South Carolina Rules of Civil Procedure (SCRCP) to reconsider and amend its Order of Remand dated July 12, 2024. It contends this Court overlooked, misinterpreted, or failed to apply certain evidence and laws applicable in this case. On July 29, 2024, the Court rescinded its Order of Remand in consideration of Petitioner's Motion. On August 2, 2024, Respondent South Carolina Department of Revenue filed Response to the Motion. After reviewing the Motion and the Response, I grant the Motion for Reconsideration and will hereafter issue an Amended Final Order.

Pursuant to SCALC Rule 29(D), a party may move for reconsideration of a final decision of this Court subject to the grounds for relief set forth in Rule 59, SCRCP. *See Elam v. S.C. Dep't of Transp.*, 361 S.C. 9, 21, 602 S.E.2d 772, 778 (2004) ("A motion under Rule 59(e) long has been viewed as 'motion for reconsideration' despite the absence of those words from the rule."); *see also* CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2810.1 (2d ed. 1995) (observing that Rule 59(e) motions may be appropriate to preserve an issue raised in a contested case for appellate review or to ask the court to decide an issue which has been raised but not ruled upon, but they "may not be used to relitigate old matters"). Petitioner argues this Court should reconsider its Order of Remand on the following fourteen grounds with attendant sub-issues:

1. The Court erred in remanding this case and ordering the application of the *Finnigan* method.



2. The Court erred in issuing rulings that directly and indirectly impact CarMax West, which is not a party in this case.
3. The Court erred in denying CarMax East's Motion in Limine and in allowing the Department's expert to provide testimony on the accuracy of the E&Y 2004 Valuation at trial.
4. The Court erred in making certain rulings regarding the 2004 Valuation.
5. The Court applied the wrong legal standard for step one under the AA statute [S.C. Code Ann. 12-6-2320].
6. The Court should reconsider its rulings that origination fees were owed to CarMax East.
7. The Court should reconsider its ruling that CarMax East should get credit for assets CarMax West contributed to CBS in the 2004 restructuring.
8. The Court is confusing "economic substance" in § 482 regulations with and improperly using the economic substance doctrine and related legal doctrines.
9. The Court erred in making certain transfer pricing rulings.
10. The Court misinterpreted and misapplied the AA statute in finding that CUR is reasonable and equitable here.
11. The Court's ruling will make South Carolina an outlier and negatively impact taxpayers' reliance interests.
12. The Court should not reward trial by ambush.
13. The Court misunderstood certain facts, which led to erroneous factual findings and legal conclusions.
14. Additional requests for clarification.

Ultimately, although review of Petitioner's grounds for this Motion caused me to rethink my reasoning on some issues in this case, I arrived at the same result. Therefore, I grant the Motion and issue an Amended Final Order that better explains my application of the facts and the law in this case. I also briefly address in this Order the grounds of Petitioner's Motion that I found were without merit or were a reiteration of arguments made at the hearing.

DISCUSSION

1. Whether the Court erred in remanding this case and ordering the application of the *Finnigan* method.

CarMax argues that "[n]o party requested or argued that the Court remand the case to the Department for the *Finnigan* method to be applied or for the Department to issue new assessments against CarMax East and CarMax West, the latter of which is not a party."¹ CarMax further asserts

¹ With respect to ordering relief that included CarMax West, I will address that issue under heading 2.

that because this specific relief was not requested by either party, ordering such relief violated “CarMax East and CarMax West’s due process rights under the Due Process Clause contained in Article I, Section 3 of the South Carolina Constitution and the Due Process Clause of the United States Constitution because, *inter alia*, they had no notice that the Court would be ruling on this issue and thus were denied the opportunity to present a defense thereon.”

In its response to the Motion, the Department explains the *Finnigan* method only makes a substantive difference when at least one member of the unitary group does not have a nexus to South Carolina. The Department argues that here, where all members of the unitary group have a nexus to South Carolina, applying the *Finnegan* method is a nonissue. The Department further explains that it audited both CarMax East and CarMax West and it “would have separated the liability/refund” between CarMax East and CarMax West had Petitioner requested, but for “administrative efficiency and consistent with Department practice, the Department issued a single net assessment to CarMax East.” Thus, as this Court noted in its Order of Remand, the Department assessed taxes for the group through CarMax East and credited CarMax West’s prior payment during the audit period. Accordingly, whether the Department splits the taxes assessed under combined unitary reporting (CUR) or not (which it says it is prepared to do if so ordered), the tax owed to South Carolina by the unitary group remains the same.

Having the benefit of the Department’s explanation, the Court concludes that remand was unnecessary. The parties do not contest that this case involves a unitary group and it is now clear that the Department audited both group members. It is thus reasonable for the Department to issue one assessment under CUR to CarMax East with credit for CarMax West’s previous payment. Moreover, it appears that while Petitioner took issue with the Department’s application of CUR, it did not ultimately object to CarMax East receiving the assessment with a credit for CarMax West’s payment. Therefore, I grant Petitioner’s Motion for Reconsideration because a remand is not necessary, and I will hereafter issue an Amended Final Order.

Although I determine a remand is no longer appropriate, I stress a court always has the inherent authority to remand, when appropriate, regardless of whether a party requests a remand or not. On page 72 of its proposed order to this Court, Petitioner asserted the Department violated Revenue Ruling 15-5 when it failed to conduct intrastate apportionment between CarMax East and CarMax West. Mystifyingly, in its Motion, Petitioner now complains that this Court ordered a remand to address this issue, which Petitioner raised. Undoubtedly, Petitioner wanted this Court

to conclude that the alleged violation of Revenue Ruling 15-5 required reversal of the Department's decision, but the Court is not required to do so and has the inherent authority to remand a matter based upon its determination of the facts and the law. *See, e.g.*, S.C. Code Ann. § 1-23-380(5) ("The court may affirm the decision of the agency or remand the case for further proceedings."); *Torrence v. S.C. Dep't of Corr.*, 433 S.C. 224, 228, 857 S.E.2d 549, 550 (2021) ("Where a remand to the agency is ordered, yet it is believed the order of the ALC finally determines the rights of the parties and constitutes a final judgment, the aggrieved party may allow the remand to conclude without forfeiting its right to appeal."). Certainly, remand is a potential outcome for which Petitioner had adequate notice considering it raised the issue itself, even if it was not Petitioner's desired outcome. *See Olson v. S.C. Dep't of Health & Env't Control*, 379 S.C. 57, 69, 663 S.E.2d 497, 503 (Ct. App. 2008) ("Due process requires (1) adequate notice; (2) adequate opportunity for a hearing; (3) the right to introduce evidence; and (4) the right to confront and cross-examine witnesses."); *id.* at 69, 663 S.E.2d at 504 ("The fundamental requirement of due process is the opportunity to be heard at a meaningful time and in a meaningful manner."); *id.* ("To prevail on a claim of denial of due process, there must be a showing of substantial prejudice.").

Since I find a remand is no longer appropriate, I decline to address the rest of Petitioner's arguments related to it.

2. Whether the Court erred in issuing rulings that directly and indirectly impact CarMax West, which is not a party in this case.

Petitioner argues the Court's Order contains many rulings that directly and indirectly materially impact the rights of CarMax West, a non-party, in violation of its due process rights. *Ex parte Hart*, 190 S.C. 473, 473, 2 S.E.2d 52, 55 (1939) ("As the county was not made a party to that proceeding, [the court] had no jurisdiction of the county, and therefore his order is void as to it."). The Court finds it overlooked the exclusion of CarMax West as a party when it ordered the Department to issue new assessments to both CarMax East and CarMax West after applying the *Finnegan* method.² Therefore, the Court's Amended Final Order will not order relief that directly affects CarMax West's legal rights.

² While the Court does not ultimately find the failure to include CarMax West as a party to this case to be fatal, it certainly appears the better practice would be to include all members, even if the members of the group were initially treated as a single entity for the purpose of assessing taxes.

Regarding “indirect” impacts to CarMax West’s legal rights, as a member of the unitary group involved in this action, the Court cannot remove all mention of CarMax West from its order. Thus, the Court’s factual findings about how the group operates and the transactions between the group members were necessary to resolve this case. These findings were, and are, intended to be made in the context of CarMax East’s rights, which shall be clarified in the Amended Final Order.

3. Whether the Court erred in denying CarMax East’s Motion in Limine and in allowing the Department’s expert to provide testimony on the accuracy of the E&Y 2004 valuation at trial.

The Court does not find it erred. Additionally, this matter was already argued before the Court via motion, at trial, and in Petitioner’s proposed order. *See* CHARLES ALAN WRIGHT & ARTHUR R. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 2810.1 (2d ed. 1995) (observing that Rule 59(e) motions may be appropriate to preserve an issue raised in a contested case for appellate review or to ask the court to decide an issue which has been raised but not ruled upon, but they “may not be used to relitigate old matters”). However, the Court will address this issue in its Amended Final Order to the extent the arguments in this section require further clarification of the Court’s reasoning.

4. Whether the Court erred in making certain rulings regarding the 2004 valuation.³

The Court will address this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court’s reasoning.

5. Whether the Court applied the wrong legal standard for step one under the AA statute.

The Court does not find it erred. The Court will address this issue in its Amended Final Order to the extent the arguments in this section require the Court to further clarify its reasoning.

6. Whether the Court should reconsider its rulings that origination fees were owed to CarMax East.

The parties spent a significant amount of time and energy discussing CAF and origination fees during the trial; therefore, the Court needed to discuss them in its Order. However, the Court

³ One of Petitioner’s sub-issues under this heading provides a quote from the Court’s Order and then asserts, “This is not an accurate statement.” However, Petitioner does not explain why the statement is inaccurate or provide a corrected statement. Petitioner makes similar assertions throughout the Motion without providing any guidance to the Court regarding why its statements are wrong, making it extremely difficult for the Court to address these alleged inaccuracies.

gave little weight to evidence on the topic of origination fees, and its impact on the outcome of the case was de minimus. Nevertheless, the Court will address this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court's reasoning.

7. Whether the Court should reconsider its ruling that CarMax East should get credit for assets CarMax West contributed to CBS in the 2004 restructuring.

Petitioner's central complaint throughout this section of its Motion, which includes four sub-sections and various bullet-points, is that the Court *sua sponte* raised this issue and ruled upon it. The Court did not *sua sponte* raise an issue in this case; rather, it made findings based upon the evidence presented to it.

The primary issue in this case is whether the movement of money between the members of the CarMax unitary group resulted in the extent of CarMax East's business activity not being fairly represented pursuant to the AA statute. One of the ways in which money moved in this case was through the CBS partnership and its distributive shares, which the Department identified in its audit and in its determination as a source of income shifting. At trial, the parties introduced evidence as to why CarMax West was awarded an overwhelming interest in the CBS partnership, which shifted a large portion of income from CarMax East to CarMax West. The evidence showed CarMax West was awarded a 93.5% interest in CBS based upon its contribution of certain valuable assets that it appeared to have acquired for free from CarMax East. At trial, Petitioner presented evidence that CarMax East received compensation for this transfer in the form of increased stock value because CarMax East owned 100% of CarMax West, whose value increased based upon receipt of the assets.

Thus, Petitioner was certainly on notice that the shift of money away from CarMax East was a central issue in the case. In fact, Petitioner presented evidence to dispute the claim that the CarMax East transferred assets to CarMax West for zero compensation. The Court cannot simply ignore evidence relevant to the issues (evidence that CarMax West paid CarMax East zero compensation for very valuable assets), or the implications of that evidence, simply because a party did not articulate it as a specific sub-issue. Moreover, the Court, as the finder of fact, is allowed to weigh the evidence before it and is not required to adopt Petitioner's version of the evidence. *Bivens v. Watkins*, 313 S.C. 228, 235, 437 S.E.2d 132, 136 (Ct. App. 1993).

Based upon the premise of this case, Petitioner certainly should have anticipated attacks on the way the partnership was moving money through the CarMax group; to pretend it did not

anticipate such arguments would require Petitioner to stick its head in the sand like the proverbial ostrich. Moreover, the Court does not have a duty to warn Petitioner about every conclusion it might possibly draw from the evidence submitted before it. At a certain point, the parties must anticipate the possible outcomes and defend against the ones they do not seek.

Nonetheless, while I find no merit to Petitioner's argument that it was not on notice that a transfer of assets from CarMax East to CarMax West would be relevant to this case, I acknowledge that Petitioner's argument concerning why this transfer was economically sound (stock value argument) was overlooked. Accordingly, the Court will address this issue in its Amended Final Order to the extent that Petitioner's overlooked argument changed or informed this Court's reasoning.

8. Whether the Court confused "economic substance" in the § 482 regulations with, and improperly used, the economic substance doctrine and related legal doctrines.

Petitioner complains that this Court

is making rulings that are not findings of fact but are instead legal conclusions, such as finding that CarMax West should not have received credit for contributing the BPI [business process intangibles] to CBS, or conversely, that CarMax East should have received credit for contributing the BPI contributed by CarMax West. The Court is using its legal conclusions as evidence the Department met its burdens of proof required by the AA Statute.

The Court disagrees with Petitioner's portrayal of this Court's ruling. First, it is this Court's job to make legal conclusions in addition to findings of fact. Petitioner's complaint suggests that this Court is only allowed to make one legal conclusion and its other determinations must all be findings of fact. Cases often require the resolution of more than one legal issue to resolve the ultimate issue in a case. Certainly, the Court is allowed draw conclusions, both legal and factual, to ultimately determine if the Department met its burden. Petitioner has provided no authority saying otherwise.

Petitioner's argument also suggests that an issue may not have both a factual and legal component at the same time. Mixed questions of law and fact are ubiquitous in the law. Here, for example, whether CarMax East should have received credit for transferring the BPI to CarMax West could be a legal conclusion; however, it can also be a factual conclusion that informs the next step in the analysis of the case as a whole. Similarly, the transfer of the asset can be evaluated by an economist under the § 482 regulations, but it can also be looked at for what it is factually—a transfer for zero compensation and the implications of that transfer for that value.

Ultimately, this case is **not** a transfer pricing case, but the parties presented an enormous amount of transfer pricing evidence through expert testimony from which both legal and factual conclusions and mixes thereof could be drawn. The Court was therefore required to address this evidence through the lens of transfer pricing, including the § 482 regulations' discussion of "economic substance." However, some of the Court's conclusions were merely factual conclusions, and did not rely upon some other "legal doctrine" such as "economic substance and substance over form" as suggested by Petitioner. A transaction may lack economic substance within the specific meaning of the § 482 regulations, but it can also lack substance under the plain English meaning of that phrase without reference to any doctrines or laws. The Court finds it did not err.

9. Whether the Court erred in making certain transfer pricing rulings.

The Court does not find it erred. However, the Court will address this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court's reasoning.

10. Whether the Court misinterpreted and misapplied the AA statute in finding that CUR is reasonable and equitable here.

The Court does not find it erred. In this section, Petitioner generally re-iterates arguments is previously made at trial or in its proposed order. *See* Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure § 2810.1 (2d ed. 1995) (observing that Rule 59(e) motions may be appropriate to preserve an issue raised in a contested case for appellate review or to ask the court to decide an issue which has been raised but not ruled upon, but they "may not be used to relitigate old matters"). To the extent the arguments in this section changed or informed this Court's reasoning, they will be addressed in the Amended Final Order.⁴

11. Whether the Court's ruling will make South Carolina an outlier and negatively impact taxpayers' reliance interests.

The Court does not find it erred. The Court made its determination based upon the statutory law enacted by the General Assembly and case law issued by the South Carolina Supreme Court.

⁴ In this section of its Motion, Petitioner argues for the first time that "CarMax East is not arguing that CUR is forbidden by (A)(4) in all cases, nor is it arguing that CUR can never be used under (A)(4). It is only arguing that it is not allowed in this case." The central thrust of Petitioner's argument has always been that CUR is fundamentally incompatible with subsection (A)(4) because CUR results in a change to a party's federal taxable income whereas subsection (A)(4) only authorizes a change to the sales factor. Therefore, the Court is mystified by this new argument that is completely inconsistent with Petitioner's entire case up to this point.

Whether South Carolina’s law makes it an “outlier” is an issue for the General Assembly. Indeed, the General Assembly recently amended the statute at issue in this case, which now provides further guidance on the application of CUR under this state’s statutory scheme. S.C. Code Ann. § 12-6-2320; 2024 Acts No. 113.

12. Whether the Court rewarded trial by ambush.

Petitioner argues this Court “should not reward the Department’s trial by ambush, as it is neither reasonable nor equitable, and it violates CarMax East’s rights to notice, a fair trial, and additional due process rights.” Petitioner complains it was not put on notice that the Department’s expert, Dr. DeRamus, would discuss the 2004 valuation study, or that the Department would present testimony about CAF.

Petitioner’s argument circles back to its contention that its Motion in Limine should have been granted. However, as the Court determined in its Order of Remand, Petitioner’s argument that it could not have reasonably anticipated the Department’s challenge to the Valuation Study and was wholly unprepared (and therefore prejudiced) to discuss a document it provided in support of its case appeared disingenuous. Moreover, Petitioner submitted the Valuation Study as a joint exhibit and therefore “opened the door” for the Department to attack it. Petitioner was also able cross-examine Dr. DeRamus about his qualifications to give an opinion about the study and his understanding of the transactions involved in the study, and also his understanding of CAF. Petitioner’s cross-examination did not fall on deaf ears, and this Court gave the weight it thought proper to the testimony elicited about the valuation study and CAF. The most impactful conclusion the Court drew from all of this evidence was that the assets valued in the 2004 Valuation Study, and in particular the business process intangibles, were very valuable. Therefore, I do not find that the Court condoned or rewarded a trial by ambush.

13. Whether the Court misunderstood certain facts, which led to erroneous factual findings and legal conclusions.

Petitioner appears to claim that this Court adopted Dr. DeRamus’s assertedly incorrect arm’s length price for the Management Fee in its Order of Remand. The Court never adopted Dr. DeRamus’s suggested price for the Management Fee. The Court merely found the Management Fee was unreliable. Petitioner also asserts that “[n]umerous calculations provided during the case in chief that this Court appears to have adopted are also wrong.” Petitioner then provides only one

example of a number it believes is materially wrong and does not correct the number.⁵ It is unclear how the Court is supposed to correct these “numerous calculations” that it allegedly wrongly adopted without them being specifically pointed out and without an allegedly correct number for comparison. I do not find the Court erred.

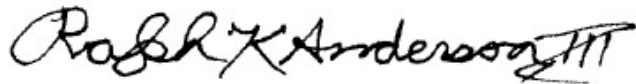
14. Additional requests for clarification.

The Court will clarify the three statements Petitioner identified in its Motion, to the extent clarification is required, in its Amended Final Order.

ORDER

IT IS HEREBY ORDERED that Petitioner’s Motion for Reconsideration is **GRANTED** and an Amended Final Order shall be issued.

AND IT IS SO ORDERED.

A handwritten signature in black ink, reading "Ralph K. Anderson III". The signature is fluid and cursive, with the "R" and "A" being particularly large and stylized. It is written above a horizontal line.

Ralph King Anderson, III
Chief Administrative Law Judge

August 15, 2024
Columbia, South Carolina

⁵ Specifically, Petitioner argues its South Carolina stores did not have an operating profit of approximately \$90,000,000 in operating profit over the audit period as found by the Court. This finding is based upon testimony in the transcript at page 322, line 17, through page 324, line 3.

CERTIFICATE OF SERVICE

I, Stephanie Perez, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).



Stephanie Perez
Judicial Law Clerk

August 15, 2024
Columbia, South Carolina

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Sep 13 2024

SC Court of Appeals

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc.,	)	Docket No. 21-ALJ-17-0182-CC
	)	
Petitioner,	)	
	)	
v.	)	ORDER OF REMAND
	)	
South Carolina Department of Revenue,	)	
	)	
Respondent.	)	
_____	)	

This matter is before the South Carolina Administrative Law Court (Court) pursuant to a request for contested case filed by CarMax Auto Superstores, Inc., (Petitioner or CarMax East) on June 8, 2019. Petitioner contests the final agency decision of the South Carolina Department of Revenue (Department), in which the Department, following an audit, imposed an alternative apportionment method to assess additional corporate income taxes and interest for fiscal years 2016–2018 (the audit period).¹ As of June 14, 2021, the assessment totaled \$2,224,389.00 for the audit years.²

The Court held a hearing on the merits at its offices in Columbia, South Carolina, from May 23, 2023, through May 26, 2023. Based upon my review of the testimony, the evidence presented, and the parties' arguments, I conclude the matter must be remanded to the Department.

MOTION IN LIMINE AND SUBSEQUENT RULING

On April 21, 2023, Petitioner filed a Motion in Limine to Exclude Expert Testimony Challenging the 2004 Valuation Study (Motion).³ Petitioner sought to exclude certain testimony

¹ The Department imposed the alternative apportionment method known as combined unitary reporting (CUR) pursuant to subsection 12-6-2320(A)(4) of the South Carolina Code (2014).

² This amount does not include any interest or fines that have since accrued.

³ The 2004 valuation study (Valuation Study) was conducted by the accounting firm Ernst and Young (E&Y) for the purpose of valuing the contributions to CarMax Business Solutions, LLC (CBS), a partnership created by CarMax East and CarMax West. I will discuss the genesis of CBS in more detail in the Findings of Fact. For the purpose of understanding the basis for the Motion, it is important to know that CarMax West made a valuable contribution to CBS, which was translated to a large ownership percentage of the partnership based upon values identified in the Valuation Study. The parties dispute whether CarMax West or CarMax East should have been credited with this contribution and received a commensurate ownership percentage in CBS. Ownership percentages are important in this case because, for tax purposes, CBS's profits flow back to its owners proportionate to their ownership percentages. In this case, whether too much of CarMax East's income is flowing through CBS back to CarMax West is a central issue



of Dr. David DeRamus, Respondent's expert witness, that would challenge the Valuation Study. Petitioner argued four grounds in its Motion: (1) the Valuation Study is nearly twenty years old; (2) the Department did not challenge the Valuation Study; (3) the Department did not disclose the Valuation Study as a subject of potential expert testimony; and (4) the Valuation Study is not relevant to any issue in the case.

On May 2, 2023, the Court held a conference call on the Motion. During the conference call, the Department admitted it did not directly cite to or challenge the Valuation Study in its determination; however, it argued (1) the transfer prices at issue in this case are intimately tied to the Valuation Study, (2) its expert disclosure was sufficient to put Petitioner on notice that the Valuation Study could be reviewed, and (3) it could challenge the Valuation Study because CarMax East presented the study as support for its position in the case.

In the Court's view, both parties made valid points. On the one hand, the Department failed to give clear notice that it intended to specifically challenge the Valuation Study through its expert or otherwise. Indeed, the Valuation Study was not a proposed exhibit for Dr. DeRamus's deposition. On the other hand, Petitioner's argument that it could not have reasonably anticipated the Department's challenge to the Valuation Study and was wholly unprepared (and therefore prejudiced) to discuss a document it provided in support of its case seemed disingenuous. Accordingly, the Court orally ruled the Department could not introduce the Valuation Study in its case in chief but could attack it if Petitioner "opened the door."⁴

At the hearing, Petitioner renewed its Motion.⁵ The Court initially upheld its previous oral ruling, but also held the ruling could change based upon the evidence presented. Ultimately, after several continuing objections and discussions, the parties made the Court aware that the Valuation

in this case. Thus, Respondent's ability to attack or otherwise challenge the Valuation Study is a central disagreement between the parties and was the subject of this Motion and numerous objections during trial.

⁴ On May 8, 2023, after the Court's ruling on the Motion, the Department filed a response in opposition to the Motion to ensure the record clearly reflected the opposition it expressed in the conference call. In its response, the Department argued it could challenge the Valuation Study because CarMax East presented it as support for its position that an alternative apportionment method is improper in this case. It further argued the subject of the Valuation Study fell within the scope of Dr. DeRamus's expert disclosure, Dr. DeRamus was qualified to offer testimony on the Valuation Study, and CarMax East deposed him on the subject.

⁵ At the time Petitioner renewed its Motion, the parties did not make the Court aware that the Valuation Study was being introduced as a joint exhibit, which would have affected the Court's ruling at that time.

Study had already been admitted as Joint Exhibit 55.⁶ After this revelation, the Court ruled that Petitioner had opened the door to Respondent attacking the 2004 Valuation Study by agreeing, without objection, to admit it as an exhibit.

FINDINGS OF FACT

Having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of proof and the credibility of the witnesses, I make the following findings of fact by a preponderance of the evidence.

History of The CarMax Group

CarMax, Inc., (CarMax) began its operations in 1993 under the ownership of Circuit City stores, Inc (Circuit City). At that time, CarMax Auto Superstores, Inc. (CarMax East) and CarMax Auto Superstores West Coast, Inc. (CarMax West) were subsidiaries of CarMax. CarMax East owned the majority of the company's retail operations, which were located in eastern states. It also performed back-office support functions and finance functions for the company. CarMax West owned the company's western retail stores and owned the company's tradenames and trademarks (intellectual property or "IP").⁷

In 2002, CarMax separated from Circuit City and emerged as a separate publicly traded company. After the separation, CarMax became the parent holding company for three subsidiaries: CarMax East, CarMax West, and Glen Allen Insurance, Ltd. (GAIL). CarMax East continued to hold the majority of the company's retail operations, back-office support functions, and finance functions.⁸ CarMax East also owned its own subsidiaries, including CarMax Properties, LLC (performed real estate functions for the group) and CarMax Auto Funding, LLC (provided

⁶ Although it is referred to as the 2004 Valuation Study, the study itself, as demonstrated by Joint Exhibit 55, is dated March 15, 2005. The parties clarified during trial that the 2004 Valuation Study and Joint Exhibit 55 are one and the same.

⁷ CarMax West has always owned the trademarks and tradenames; they have never been owned by CarMax East. It is unclear who developed the trademarks and tradenames—CarMax East, CarMax West, or the original parent company, CarMax. Nevertheless, CarMax East defended the trademarks and tradenames and developed the marketing and advertising strategies that supported the trademarks and tradenames from at least 2002 until CBS was formed in 2004. Therefore, CarMax East played an important role in maintaining and developing further value for the IP between 2002 and 2004, if not prior to that as well.

⁸ CarMax East also owned the "Business Process Intangibles," such as they were at the time. Of the business process intangibles that existed at the time of the audit—CarMax Book, ASRP, and ACR—only ASRP existed at this time. CarMax Book and ASRP were subsequently developed by CBS after CarMax went through restructuring in 2004.

financing). CarMax West continued to own the California and Nevada retail operations and also owned the CarMax IP. GAIL was a captive insurance company that provided workers' compensation and garage liability insurance plans.

In early 2004, CarMax began the process of restructuring its business and employed the firm of Ernst and Young (E&Y) to advise it. In an presentation given on April 6, 2004, CarMax's Board of Directors (Board) considered consolidating the shared services functions within the group into a new LLC (CarMax Business Services or "CBS") that would house the headquarters operations, the administrative and decision-making functions, and the company's financing activities.⁹ They also considered the benefits of reorganizing the company to provide better legal protections (isolating its California liability) and to facilitate compliance with new legislation like the Gramm-Leach-Bliley Act.¹⁰ Overall, according to the Board minutes, the Board determined the proposed restructuring would allow CarMax "to realize greater operational, legal and tax advantages than were being realized under the current structure." The Board approved the restructuring plan; however, it was changed and tweaked over the next several months.

Although most of the restructuring was implemented on December 1, 2004, some parts of the process were implemented before then. On April 23, 2004, CarMax West formed CarMax Business Services, LLC (CBS), a single-member Delaware limited liability company. Thereafter on April 28, 2004, CBS formed CarMax Superstores Services, Inc. (CASS), a Virginia corporation and wholly owned subsidiary of CBS. CASS would later become the holding company for CarMax's employees. Finally, on May 3, 2004, CarMax West formed CarMax Auto Superstores California, LLC, a single-member limited liability company.

⁹ Indeed, having the financing activities located in CAF under CarMax East was causing issues and confusion with regulators. Generally, after a customer purchases a car using financing through a retail installment contracts (RICs), the RIC is reassigned to a third-party because most dealers do not service their own financing. However, under CarMax's structure, CarMax East was selling the vehicle and providing direct financing without reassigning its RICs, whereas CarMax West was reassigning its RICs to CarMax East. This arrangement caused confusion and difficulty with regulators. Separating retail sales from financing would clarify each business's role and the regulations under which it was required to operate.

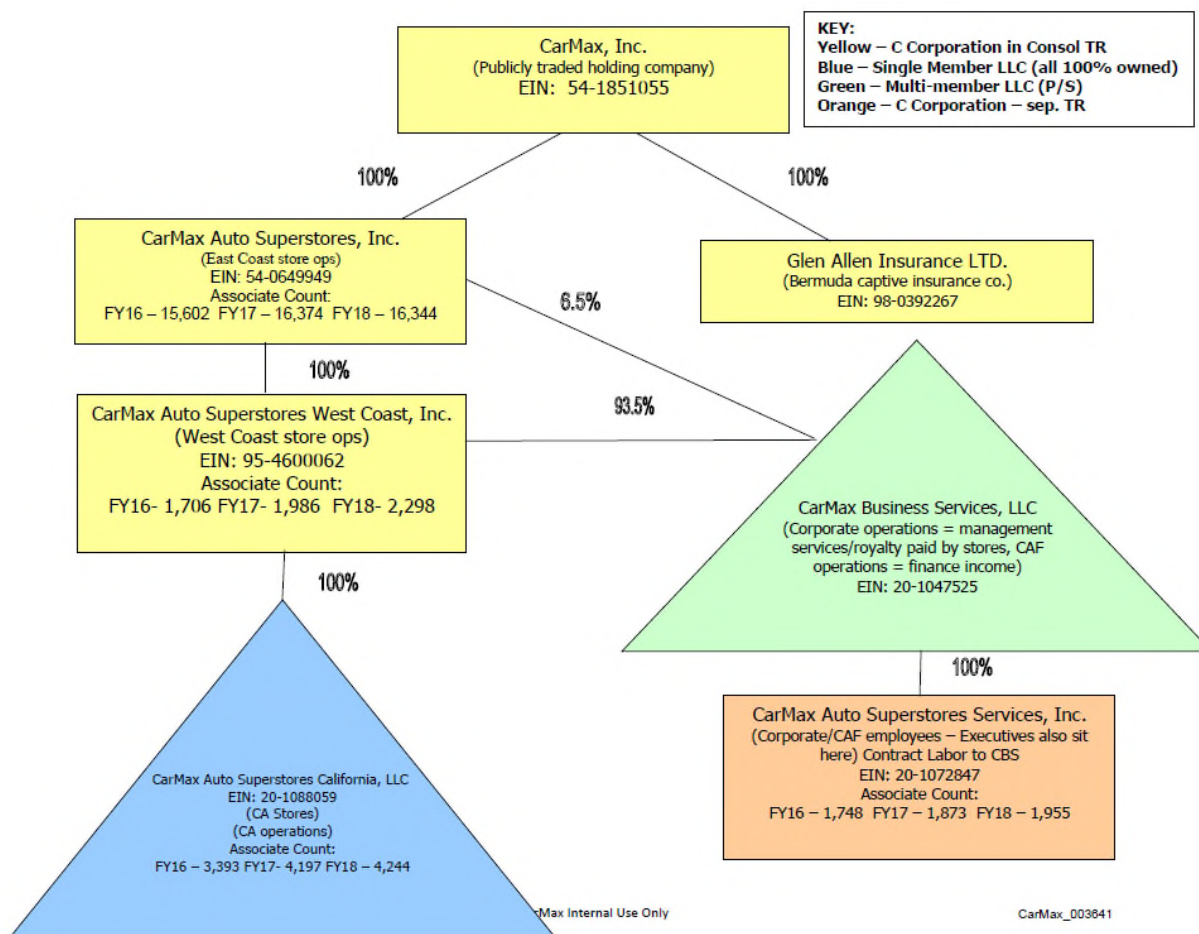
¹⁰ 15 U.S.C.A. § 6801 (Westlaw).

Then, on December 1, 2004, CarMax took the following steps to effectuate the restructuring:

1. CarMax West contributed its California stores to CarMax Auto Superstores California, LLC.
2. CarMax (the parent holding company) contributed 100% of its stock in CarMax West to CarMax East.
3. CarMax East contributed its Business Process Intangibles¹¹ and West Creek land to CarMax West.
4. CBS became a partnership and received the following contributions:
 - a. CarMax West contributed the Business Process Intangibles, the West Creek land, and the CarMax IP. In exchange for these contributions, CarMax West received a 93.5% ownership interest in CBS.
 - b. CarMax East contributed the Business Functions (headquarters functions), certain contractual obligations, and some cash. In exchange, CarMax East received a 6.5% ownership interest in CBS.
5. CBS contributed the employee workforce to CASS and entered into an employee servicing agreement with CASS.
6. CBS entered into the Master Management Service Agreement (MMSA) with CarMax East, CarMax West, and CarMax California.

¹¹ According to Petitioner, the “Business Process Intangibles” contributed to CBS were proprietary systems and some trade secrets.

Thus, after the restructure, CarMax (the CarMax Group) was structured as depicted below:



Master Management Service Agreement

As part of the restructuring, CarMax East, CarMax West, and CarMax California entered into a Master Management Services Agreement (MMSA) with CBS.¹² Under the MMSA, CBS agreed to provide the other members of the agreement with back-office services (legal services, finance and accounting, human resources, information technology, sales operations, and training), real estate services, marketing and advertising services, and quantitative analytics services. In exchange for these services and for managing the IP, CBS charged a Management Fee, which was a flat fee charged per vehicle sold.

¹² Collectively, CarMax East, CarMax West, and CBS are the CarMax entities primarily at issue in this litigation and the parties do not dispute that they make up a unitary group.

Effect of the 2004 Restructuring

From the customer's perspective, the restructuring had no effect on their experience shopping at CarMax. However, internally, the restructuring changed the assigned functions of the different CarMax entities. For example, prior to the restructuring, CarMax East performed the back-office functions. Afterwards, CBS took over those functions.

From a tax perspective, the restructuring had a significant effect because the MMSA and the partnership affected the flow of income between the companies. Specifically, because CBS is structured as a partnership, it is not directly taxed. Rather, the income it generates flows back to its partners—CarMax East and CarMax West. Therefore, whatever income CBS earns, through the MMSA and otherwise, is distributed back to CarMax East and CarMax West for tax purposes. Based upon the assigned ownership percentages of CBS, CarMax West receives 93.5% of CBS's income and CarMax East receives 6.5% of CBS's income.

The effect of this structure during the audit period is stark. During this period, CBS generated about half of its income from the Management Fees it charged CarMax East and CarMax West. Since CarMax East was the owner and operator of the vast majority of the retail stores (approximately 75%), it was the source of the majority of CBS's income from the Management Fees. Nevertheless, because CarMax West was assigned a 93.5% interest in CBS during the restructuring (primarily due to its contribution of the business process intangibles), almost all of CBS's income flowed back to CarMax West, which only originated approximately 25% of CBS's Management Fee income. Thus, as a result of the flow of income through the partnership, CarMax's East taxable income significantly decreased while CarMax West's taxable income significantly increased. More specifically, CarMax East generated about 75% of the Group's revenues but was only attributed with about 20% of the Group's taxable income because the rest of its revenue that would have become taxable income was shifted to CarMax West. In contrast, CarMax West only produced 25% of the Group's revenues but was attributed with about 80% of its taxable income.

Unsurprisingly, the combined effect of the Management Fee and the partnership distributions also significantly reduced CarMax East's South Carolina taxable income. Over the course of the three audit years, CarMax East's South Carolina stores had a total operating profit of approximately \$90,000,000; however, their taxable income apportioned to South Carolina was

only about \$21,000,000. The delta between these values reflects the movement of income from CarMax East to CarMax West through the Management Fee and the partnership terms.

The CarMax Business During the Audit Period¹³

During the audit years, CarMax held itself out as the largest retailer of used cars in the United States.¹⁴ It competed with franchised dealers selling new and used cars, independent used cars dealers, online and mobile sales platforms, and private parties. CarMax East and CarMax West owned and operated 188 retail stores by the end of the audit period. CarMax East owned 75% of those stores (141), including four stores in South Carolina by the end of the audit period. CarMax West did not own any stores in South Carolina.

Business Model

CarMax's goal was "to deliver unrivaled customer experience by offering a broad selection of high quality used vehicles and related products and services at low, no-haggle prices using a customer-friendly sales process in an attractive, modern sales facility." Its competitive strategy was to address customer dissatisfaction with traditional methods of retail in the auto industry, including high pressure sales tactics and unclear pricing.

To create a low-pressure sales atmosphere for the customer, CarMax associates were generally paid a fixed commission per vehicle to negate the need for up-selling and to retain focus on the customers' needs. Additionally, each aspect of CarMax's sales business had a discrete, transparent cost for the customer, so the customer could choose which transaction(s) he wished to pursue. For example, customers could sell their cars to CarMax through CarMax's "appraisal lane" with or without purchasing a "new" used car from CarMax.¹⁵

CarMax also strove to differentiate its sales by providing its customers with access to its national inventory through its website and mobile app. For example, in FY2016, CarMax had over 55,000 cars available in its national inventory. If a customer found a car they wanted in the national

¹³ Generally, the information in this section is from CarMax's 10-K for FY2016. A review of CarMax's 10-Ks from FY2017 and FY2018 showed no significant changes to its business model for the purpose of this case.

¹⁴ At the time of the audit, CarMax sold new vehicles at two locations under franchise agreements, but new vehicles were not the focus of its business or the primary source of its income. Generally, CarMax focused on selling used vehicles from 0-10 years old that had less than 100,000 miles.

¹⁵ According to CarMax, during the audit period less than fifty percent of the vehicles it purchased in its appraisal lane met its retail standards. As a result, it developed a large wholesale operation wherein the vehicles that did not meet its standards were sold to licensed dealers through its on-site wholesale auctions. Wholesale sales were a significant part of CarMax's business.

inventory, CarMax would transfer the vehicle to the customer's local store at the customer's request.

Sales

Over the course of the audit period, CarMax was a profitable company with healthy operating margins. During this time, CarMax East sold about 1.5 million vehicles, which equated to about 75% of the Group's sales. Also, CarMax East and CarMax West sold extended protection plans (EPPs). These plans included extended service plans (ESPs)¹⁶ and guaranteed asset protection (GAP) coverage. CarMax estimated that in FY2016, more than 60% of its customers purchased an ESP and about 25% purchased GAP coverage.

Financing

CarMax provided financing to its customers through its subsidiary, CarMax Auto Financing (CAF), which was owned by CBS. CAF used proprietary scoring models to analyze customers' credit histories and predict the likelihood of a customer payment for the purpose of offering financing directly through CAF or through its third-party financing partners. CAF serviced all the loans it originated during the audit years.¹⁷ In FY2016, CAF serviced approximately 704,000 customer accounts in its \$9.59 billion portfolio of managed receivables.

CAF generated the bulk of its income from the interest it collected on car payments; however, it also made some income off of late fees, etc. Financing income accounted for roughly 25% of the company's gross profits each year of the audit. The finance business was successful, in part, because it has a high profit margin.

Financing Process

CarMax did not have finance managers at the retail stores. Rather, retail store employees assisted customers in submitting credit applications online for financing. Then, CAF and CarMax's third-party financing partners reviewed the applications to determine whether the customers were eligible for financing. A financing offer was then electronically returned to the local store employees who presented the financing options to the customers. After the customers selected a financing option, the employees assisted the customers with filling out the paperwork for the

¹⁶ Customers who purchased ESPs could have their vehicle serviced at local CarMax stores or at thousands of independent and franchised service providers.

¹⁷ About once a quarter, CAF will bundle a group of loans, securitize them, and sell them on the public market. However, CAF remains the servicer of these loans.

financing, known as a retail installment contract (RIC). Once complete, the RICs were assigned from the local store to either CAF or the third-party lender. Notably, CAF, through CBS, did not pay the local stores an origination fee for the loans they initiated.

CBS's Back-Office Services

As explained above, CBS provided several back-office services to CarMax East and CarMax West during the audit period. These services included legal services, finance and accounting, human resources, information technology, sales operations, training, real estate services, marketing and advertising services, and quantitative analytics services. CBS also owned and managed the trademarks for CarMax. CBS was compensated for these services through a flat, per car Management Fee under the MMSA. CBS also owned and managed CAF.

CBS was profitable during the audit period. About half of CBS's income came from the Management Fees it collected under the MMSA and about half of its income came from CAF's financing business. Over the three audit years, CBS had a total income of approximately \$2 billion. Because CBS is a partnership owned by CarMax East and CarMax West, its income was ultimately sourced back to CarMax East and CarMax West in proportion to their ownership interests for the purpose of taxation.

Trademarks and Tradenames

During the audit years, CBS owned CarMax's IP. It was responsible for monitoring the trademarks and tradenames, sending cease and desist letters, and applying for patents. CBS hired third-parties, as needed, to assist it with these duties. CBS licensed the IP to CarMax East and CarMax West through the License Agreement. Under the License Agreement, in exchange for the use of the IP, CarMax East and CarMax West agreed to pay CBS a license fee, pursuant to the MMSA, as part of the Management Fee.

Marketing and Advertising

CBS owned and operated CarMax's website and was responsible for marketing and advertising for CarMax. For example, it was responsible for media buying, broadcast media, commercials, and creative work. It was also responsible for market analytics and customer insight

surveying.¹⁸ The retail stores also engaged in some of their own advertising and were responsible for executing the retail strategies developed by CBS.

CarMax's advertising strategy focused on developing awareness of the advantages of shopping at its local stores and at carmax.com. CarMax used traditional and digital methods to advertise, including social media. It provided detailed, sophisticated search engines for customers to navigate its website to find the right vehicle. According to CarMax, approximately 88% of its customers who purchased a vehicle had first visited CarMax online. CBS also contracted with an external firm, Horizon Media, to plan and place some of CarMax's advertising, including local and national television, radio, digital, and outdoor media (billboards, e.g.).

Real Estate Services

CBS housed the real estate services department, which was responsible for acquiring property for the stores and ensuring the stores were properly permitted and zoned. The real estate team was also responsible for property management after stores were opened. This department also worked with other strategic teams at CBS, like marketing and advertising, to engage in expansion planning.

Quantitative Analytics Group

CBS's quantitative analytics group (data science team) developed proprietary systems to assist with several aspects of CarMax's business—like pricing and reconditioning.¹⁹ These proprietary systems are also known as “business process intangibles.” CarMax asserts its proprietary systems drove much of the company's value generation.²⁰

¹⁸ The MMSA outlined CBS's specific advertising and marketing duties, which included: performing market analysis for potential locations; market research to distinguish CarMax; market analysis on test drives and purchase; “enterprise-wide” marketing strategies; developing campaigns, promotions, and advertisements; procuring all television, print, radio, and online advertising; creative development of the website, direct marketing campaigns, developing names, logos, slogans, tradenames, etc.; and providing specific decision making guidance to local stores.

¹⁹ Specifically, under the MMSA, CBS agreed to provide the following “analytical and business development services”: develop algorithms to enhance the efficiency and profitability of the business; capture and analyze data from across all lines of business to develop proprietary formulas to enhance inventory buying and management functions; capture and analyze data to develop proprietary formulas to enhance the inventory mix and obtain maximum profitability; provide specific decision making guidance with respect to which vehicles to purchase, including information as specific as the model, make, year, mileage, options, and overall condition.

²⁰ CarMax also asserts that it considered outsourcing the data systems work in the past, but ultimately determined it was more advantageous to keep this service in house.

Three propriety systems were specifically identified at trial: ASRP, CarMax Book, and ACR (appraisal cost recovery).²¹ CarMax first developed the ASRP system around 2003, before CBS's creation. It uses this system to price approximately 90% of the cars on its lots. Then, CBS developed CarMax Book, which functions like Kelly Blue Book. CarMax has used this system since approximately 2011 to identify the most lucrative price to pay for a used car at auction.²² Finally, CBS developed ACR to price cars in its appraisal lane to boost its gross margins. CarMax is currently on its ninth or tenth iteration of ACR.

The goal of all these systems was to improve margins; then, the executive team would determine if the extra margins should be realized as profit or through lowering the customer's price. Thus, while the retail stores ultimately brought in revenue for CarMax through sales, many of the decisions underlying the sales—like how to price a car or how much to pay for a car—were guided by the proprietary systems developed by CBS.

CarMax's Business Activity in South Carolina

During the audit period, CarMax East's business activity in South Carolina was selling and purchasing cars as well as the sale of EPPs. CarMax East had three stores located in South Carolina for most of the audit period and added a fourth store at the end of the audit period.

CarMax West had no business activity in South Carolina except through its 93.5% ownership interest in CBS. CarMax West was taxed on CBS's South Carolina income that flowed through the partnership back to CarMax West.

CBS's business activity in South Carolina was related to its licensing of CarMax's trademarks and tradenames and financing income from loans that originated in South Carolina. CBS's income was recognized on CarMax East's and CarMax's West's respective South Carolina tax returns.

²¹ For example, the quantitative analytics group deployed A/B testing. In this testing type, some stores (A stores) applied a newly developed algorithm for how to handle the decision to re-paint a car, and some stores (B stores) did not apply the algorithm. The quantitative analytics group then analyzed the profits from each decision type, A or B, to determine if the algorithm improved margins. As a result of this testing, CarMax implemented a decision tree about when and how to re-paint a car.

²² CBS developed several iterations of CarMax Book and tested them across auctions and regions until CarMax Book outperformed human buyers.

CarMax East's Tax Returns

For all tax years at issue, CarMax East filed its tax returns using South Carolina's standard method of separate reporting. I will use FY2016 as an example. In FY2016, CarMax East reported \$167,235,618 in taxable income on its South Carolina tax return, which is the amount of federal taxable income attributed to CarMax East (the Group's federal taxable income was \$835,068,258).²³ After South Carolina's modifications, that figure increased to a net taxable income of \$208,904,788. Then, net taxable income (\$208,904,788) was multiplied by a sales factor of 3.35%²⁴ to apportion the amount of net taxable income attributable to South Carolina. This resulted in a taxable base of \$7,010,427. South Carolina's corporate tax of 5% was then applied to arrive at a corporate income tax of \$350,521. The same method was used for the other audit years.

CarMax West's Tax Returns

CarMax West similarly filed its taxes using separate reporting for all the tax years at issue. In FY2016,²⁵ CarMax West paid \$109,407 in taxes. In total, it paid \$369,104 in taxes during the audit period and had an average sales factor of 0.33%. The sales factor's numerator included CarMax West's South Carolina retail sales (\$0), 93.5% of CBS's royalty receipts from South Carolina, and 93.5% of CBS's finance receipts from South Carolina. The denominator included all of CarMax West's retail sales everywhere, 93.5% of CBS's royalty receipts from everywhere, and 93.5% of CBS's finance receipts from everywhere.

Department Determination

In its Determination, the Department concluded that for the audit years (FY2016-2018) the use of separate reporting and the standard apportionment method did not fairly represent the extent of CarMax East's business activity in South Carolina. It further concluded that combined unitary

²³ Importantly, although CarMax East had the majority of revenue and sales for the Group in this year, its apportionment of federal taxable income (\$167,235,618 out of \$835,068,258) is remarkably low as a result of the income shifting from CarMax East to CarMax West through the Management Fee and partnership distributions.

²⁴ The sales factor was equal to CarMax East's South Carolina sales in 2016 (numerator) divided by its sales everywhere (denominator).

²⁵ To this Court's knowledge, the Department did not include CarMax West in its audit. Nor did the Department include it as a party to this case despite the fact that requiring CUR affects both CarMax East's and CarMax West's tax returns because they are part of a unitary group. The Department credited CarMax East with the tax that both CarMax East and CarMax West had already paid for the audit period; however, this is an improper application of CUR when the unitary group includes two South Carolina taxpayers. As the Court will explain later, the Department failed to apply its chosen method of how to divide taxable income between two South Carolina taxpayers within a unitary group—the *Finnegan* method.

reporting (CUR) was a reasonable alternative apportionment method pursuant to subsection 12-6-2320(a)(4) of the South Carolina Code. Pursuant to subsection 12-6-2320(a), the Department required CarMax East to use CUR for the audit years, which increased CarMax East's South Carolina taxes.

Underlying the Department's imposition of CUR was its factual determination that CarMax East "shifted most of its federal net taxable income to CarMax West via a partnership with CBS and the resulting apportionment did not fairly represent the extent of [CarMax East's] business activity in South Carolina." The Department further found that CarMax qualified for CUR under two of the three circumstances in which the Department applies it: (1) the existence of a management fee and (2) an east-west business structure.

Specifically, the Department determined CarMax utilized CBS's Management Fee to shift income from CarMax East to CarMax West through CBS. It found:

Despite only receiving 6.5% of the net income earned by CBS, CarMax East paid more than 74% of the total management fee to CBS during the Periods at Issue. This shifts CarMax East's income to CBS, who then distributes 93.5% of its receipts to CarMax West. Even if the management fees paid to CBS are proportionate to the management services provided, the difference in distributive shares shifts a disproportionate amount of income to CarMax West.

The Department further found that "[r]egardless of whether the ownership percentages [in CBS] are proportionate to the value of the assets contributed at formation of the partnership, those percentages are unrelated to CarMax East and CarMax West's respective business activity in South Carolina." Moreover, "[b]ecause the shifting is not based on the extent of CarMax East's business activity, the result is not a fair representation of [CarMax East's] business activity in South Carolina."

The Department calculated that through intercompany transactions, CarMax East reduced its federal taxable income by \$1.6 billion for the audit period while CarMax West increased its federal taxable income by \$1.4 billion. As a result, CarMax East had a net taxable income return of \$10.54 for every \$100 of income it produced while CarMax West had a net taxable income return of \$57.00 for every \$100 of income it produced. In other words, the Department calculated that although CarMax West produces much less revenue than CarMax East, CarMax West's income produces 541% more federal taxable income than CarMax East's because the Management Fee and partnership distributions siphon income from CarMax East to CarMax West.

As a result of its audit, the Department imposed CUR. Under CUR, the Group's federal taxable income—\$835,068,258—was modified to arrive at a South Carolina net taxable income of \$903,584,022. The sales factor was then adjusted for CUR such that the numerator was the Group's South Carolina sales and the denominator was the Group's sales everywhere. In 2016, this resulted in a sales factor of 2.507%. Multiplying the sales factor by net taxable income (\$903,584,022) resulted in a taxable base of \$22,652,851. The Department then applied the corporate income tax rate of 5% to arrive at an audited corporate income tax equal to \$1,132,643. The same method was used for the other audit years.

With the application of CUR, CarMax East owed additional taxes in South Carolina for each audit year. The following amounts are at issue:

Period Ended	02/28/16	02/28/17	02/28/18	Total
Tax	\$672,715.00	\$760,060.00	\$791,614.00	\$2,224,389.00
Interest*	\$149,876.59	\$129,965.49	\$92,476.89	\$372,318.97
Total	\$822,591.59	\$890,025.49	\$884,090.89	\$2,596,707.97

*The interest amount has been updated from the Proposed Assessment and is computed through June 14, 2021, and will continue to accrue until this matter is resolved.

Although CarMax disagreed with the Department's imposition of CUR, it agreed the Department correctly calculated CarMax East's tax liability under CUR.

A comparison of the two reporting methods is illustrated in the table below:

	CarMax East's South Carolina Tax Return for FY2016	Department's Use of CUR for FY2016
Line 1 ²⁶ – Federal Taxable Income	\$159,609,689	\$835,068,258
Line 2 – Net Adjustment (i.e., state law adjustments)	\$49,295,099	\$68,515,764
Line 3 – Total Net Income as Reconciled (i.e., total income subject to apportionment) ²⁷	\$208,904,788	\$903,584,022
Apportionment Ratio	3.36%	2.51%
Line 4 – Total SC Net Income	\$7,010,427	\$22,652,851

²⁶ References to line numbers correspond to the line numbers on Form SC1120 (South Carolina corporate income tax return).

²⁷ The amount on Line 3 is the net taxable income subject to allocation and apportionment in South Carolina. No income is allocated in this case, and thus the amount on Line 3 (in both columns) represents the total net income subject to apportionment.

Line 5 – Net Operating Losses	\$0	\$0
Line 6 – SC Net Income Subject to Tax	\$7,010,427	\$22,652,851
SC Corporate Tax Rate	5%	5%
Line 7 – Corporation Tax Due	\$350,521	\$1,132,643
Credit for Tax Paid by CarMax East	N/A	(\$350,521)
Credit for Tax Paid by CarMax West	N/A	(\$109,407)
Total Combined Credit for Taxes Paid	N/A	(\$459,928)
Additional Tax Owed by CarMax East	N/A	\$672,715

Valuation of CBS's Partnership Interests

In response to the Department Determination, CarMax submitted evidence to support CBS's partnership distributions. The distributions were set based upon the relative value that CarMax East and CarMax West contributed to the partnership at its formation.

CarMax East contributed the back-office functions, CAF, and some cash. CarMax calculated these contributions had a net book value (NBV) and a fair market value (FMV) of \$120,510,723.

CarMax West contributed the West Creek property, the CarMax IP, and the business process intangibles. CarMax determined the West Creek property to have a NBV and FMV of \$11,260,301, and, based upon a valuation study conducted by E&Y, CarMax assigned a FMV of \$1,996,000,000 to the IP and the business process intangibles. In total, the FMV of CarMax West's contributions totaled \$2,007,270,301.

Based upon the above valuations, CarMax East contributed 6.5% of the value to CBS and CarMax West contributed 93.5% of the value to CBS. Accordingly, CarMax assigned CarMax East a 6.5% interest in CBS and CarMax West a 93.5% interest in CBS.

The parties dispute (1) the value assigned to the IP and the business process intangibles and (2) whether CarMax East, instead of CarMax West, should have received credit for contributing the IP and the business process intangibles. To support its valuation of the IP and business process intangibles, CarMax submitted E&Y's 2004 Valuation Study. This study was based upon principles in the "482 Regulations." Therefore, before I address the valuation of the IP and business process intangibles, a brief overview of the "482 Regulations" is necessary.

482 Regulations

The 482 Regulations are derivatives of section 482 of the Internal Revenue Code, which gives the IRS the authority to reallocate income between related parties to prevent tax evasion.²⁸ 26 U.S.C.A. § 482 (Westlaw through Pub. L. 118-3) (“Allocation of income and deductions among taxpayers”); see *Sundstrand Corp. & Subsidiaries v. Comm’r*, 96 T.C. 226, 353 (1991) (“The purpose of section 482 is to prevent the artificial shifting of the net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers.”). The process of allocating income between related parties is called transfer pricing. More specifically, transfer pricing is the process by which companies assign prices to transactions between related parties (controlled taxpayers) to mimic the prices between unrelated parties (uncontrolled taxpayers) on the open market.²⁹ Because transfer pricing shifts income between related parties, it is possible for companies to abuse transfer pricing to artificially shift income from a higher tax jurisdiction to a lower tax jurisdiction. Accordingly, taxing authorities pay close attention to transfer pricing.³⁰

Because section 482 consists of only one paragraph, transfer pricing experts rely on the “482 Regulations” for guidance on how to calculate and evaluate transfer prices consistent with the IRS’s standards. 26 C.F.R. § 1.482-0 to -9 (Westlaw). The 482 Regulations contain several principles to consider when analyzing related party transactions, including the arm’s length principle and the economic substance of the transaction. 26 C.F.R. § 1.482-1(a)(1) (Westlaw through 89 F.R. 51276). The overarching objective of transfer pricing is to place the controlled taxpayer in parity with an uncontrolled taxpayer.

²⁸ South Carolina has adopted section 482, and the Department has the authority, like the IRS, to apportion or allocate income to prevent the evasion of taxes or to clearly reflect the income of an organization. See S.C. Code Ann. § 12-6-40 (2104 & Supp. 2023) (adopting the Internal Revenue Code to state tax laws); S.C. Code Ann. § 12-54-155 (2014) (discussing the application of section 482 in the context of a “substantial valuation misstatement”).

²⁹ “Controlled taxpayer means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. Uncontrolled taxpayer means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.” 26 C.F.R. § 1.482-1(i)(5) (Westlaw through 89 F.R. 51276).

³⁰ This is not to say that tax minimization strategies are either improper or not a part of good business and tax advice. Yet, to pass judicial muster, transfer pricing must be consistent with dealings in an open market. Moreover, the “establishment of a business purpose for a transaction does not necessarily insulate the taxpayer from a section 482 allocation.” *Sundstrand Corp. & Subsidiaries v. Comm’r*, 96 T.C. 226, 353 (1991).

Arm's Length Principle

Pursuant to the arm's length principle, the price between two controlled taxpayers should reflect the price to which two uncontrolled taxpayers would agree on the open market. 26 C.F.R. § 1.482-1(b) ("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."). The arm's length principle does not necessarily require a single correct price for a transaction, but generally seeks to identify a range of prices that one would expect to see in the open market. 26 C.F.R. § 1.482-1(e) ("In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived."). If the price of a controlled transaction falls outside of the arm's length range, the IRS may reallocate income and adjust the price to fall within the range—usually, the IRS adjusts the price to the range's median. 26 C.F.R. § 1.482-1(e)(3).

Economic Substance

Economic substance refers to whether the purported purpose of the transaction aligns with how the parties are actually behaving in the transaction—whether substance matches form. How the parties represent themselves legally and contractually will be respected unless there is no economic substance to the transaction. 26 C.F.R. § 1.482-1(d)(3)(ii).

In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (see, for example, § 1.482-4(f)(3) (Ownership of intangible property)). If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Id.

Functional Analysis

The 482 Regulations contain several different methods for pricing controlled transactions. 26 C.F.R. § 1.482-3 to -6 (Westlaw). Whether a certain method should be used depends upon the nature of the transaction—does it involve a good or a service or the licensing of an intangible? Who is bearing the risk in the transaction? In other words, before an appropriate method can be chosen, the transaction must have context, and this is accomplished through a functional analysis.

The result of the functional analysis not only guides the method to be used, but also the choice of comparable transactions from which a transfer price can be obtained. 26 C.F.R. § 1.482-1(d)(3)(i) (instructing that the degree of comparability between controlled and uncontrolled transactions requires a functional analysis). A functional analysis should include a comparison of “the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions” and “consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles.” 26 C.F.R. § 1.482-1(d)(3)(i).

The Best Method Rule

Once the functional analysis is complete, the analyst chooses a pricing method pursuant to the “best method rule.” The best method rule requires the analyst to use whatever transfer pricing method is the most reliable method based on the facts and circumstances of the transaction. 26 C.F.R. § 1.482-1(c).³¹ Generally, each method compares the controlled transaction with similar uncontrolled transactions (comparables) to determine an arm’s length price range. The more similar the uncontrolled transactions—the higher the comparability—the more accurate and reliable the method will be. 26 C.F.R. § 1.482-1(c)(2)(i) (“The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables . . .”).

Comparability

Depending upon the selected pricing method, higher or lower degrees of comparability may be required to reach a reliable arm’s length result. Generally, “[i]n order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm’s length result.” 26 C.F.R. § 1.482-1(d)(2). “If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such

³¹ Choosing the best method is important because even if a method appears to follow logical steps, if it produces a result that is not reliable in the particular circumstance, then it is not the best method.

differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results.” *Id.*

Data Accuracy and Completeness

The completeness and accuracy of the data available to analyze the controlled and uncontrolled transactions affects the overall reliability of a given method. 26 C.F.R. § 1.482-1(c)(2)(ii). “Deficiencies in the data used or assumptions made may have a greater effect on some methods than others” and “the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction.” 26 C.F.R. § 1.482-1(c)(2)(ii)(C). A good test of reliability is whether two different methods produce consistent results. 26 C.F.R. § 1.482-1(c)(2)(iii).

Expert Testimony

To assist the Court in evaluating the related party transactions at issue in this case, including the transfers underpinning the formation of CBS, the parties presented expert testimony. On behalf of Petitioner, Dr. Brian Joseph Cody was qualified as an expert in economics and transfer pricing. Dr. Cody has a PhD in economics. During his approximately fourteen years at the firm KPMG, Dr. Cody led the Chicago transfer pricing group, then oversaw the Western region transfer pricing, economic, and valuation services group, and finally, he headed the economic and valuation services group for KPMG’s national office. Dr. Cody spent the last twenty years of his career working predominantly within the retail industry, including leading KPMG’s retail and consumer product transfer pricing group.

On behalf of the Department, Dr. David Watlington DeRamus was qualified as an expert in transfer pricing, including economic principles. Dr. DeRamus was also qualified as an expert in valuation. Dr. DeRamus has a PhD in economics. He currently works for the economic consulting firm Bates White. He previously worked at other firms, including KPMG, many years ago. He describes himself as an applied micro economist who studies the factors that lead companies to either have high or low profits. He has performed valuation analyses for asset transfers, particularly for intangible assets, over the course of his thirty-year career.

I did not find either expert to be completely convincing. Dr. Cody’s work has been heavily concentrated in domestic retail transfer pricing, like the matter before the Court. Nevertheless, despite his experience in retail, I did not find his explanations of several transactions to be rigorous or convincing. In contrast, Dr. DeRamus’s work has been mostly associated with international

companies and the energy sector, including utilities involving the Federal Energy Regulatory Commission. However, he testified in much more detail and with a rigor and reason that made him more persuasive in several areas. Therefore, I have made my factual analysis based upon the aspects of each expert's testimony I found convincing. *See Small v. Pioneer Mach., Inc.*, 329 S.C. 448, 470, 494 S.E.2d 835, 846 (Ct. App. 1997) ("Where the expert's testimony is based upon facts sufficient to form the basis for an opinion, the trier of fact determines its probative value."); *see also Altama Delta Corp. v. Comm'r*, 104 T.C. 424, 465–66 (1995) ("We are not bound by the opinion of any expert witness, but will consider that opinion based on our analysis of the evidence in the record and applying our judgment in consideration of that evidence."); *id.* ("While we may choose to accept the opinion of one expert in its entirety, we may also be selective in the use of any portion of that opinion."). With this background in mind, I now turn to E&Y's Valuation Study and the experts' opinions of it.

E&Y 2004 Valuation Study

Based upon E&Y's 2004 Valuation Study, CarMax West was assigned its large interest in CBS's partnership, the validity of which is now at issue in this case. In the Valuation Study, CarMax tasked E&Y to value its "Car business-related intellectual property owned by CarMax as of December 1, 2004" or "car-related IP." The "car-related IP" included CarMax's IP and its business process intangibles.³² The purpose of the study was to assign value to the transfer of these intangibles from CarMax West to CBS during the restructuring.

Since the transfer of the car-related IP to CBS involved intangibles, E&Y utilized § 1.482-4 of the 482 Regulations, which governs the transfers of intangibles. 26 C.F.R. § 1.482-4 (Westlaw through 89 F.R. 41848). This section instructs that "[t]he arm's length consideration for the transfer of an intangibles determined under this section must be commensurate with the income attributable to the intangible." 26 C.F.R. § 1.482-4(a). Additionally, this section requires the use of one of four specified methods: (1) the comparable uncontrolled transaction method (CUT); (2) the comparable profits method (CMP); (3) the profit split method (PSM); or (4) an unspecified method (UM). *Id.*

³² Importantly, the study was limited to "car-related" intangibles; it did not attempt to value intangibles related to CarMax's financing operations or real estate leases. Additionally, because the business process intangibles had already been transferred from CarMax East to CarMax West by the date on which the valuation was requested, E&Y did not consider this transfer in their valuation.

E&Y determined the best method to apply was the UM.³³ Specifically, they applied a UM known as the discounted residual cash flow (DRCF) method.

Under the DRCF method, the analyst calculates projections for the business's free cash flows, discounts those projections, and then subtracts from the sum of those discounted projections the value of the parts of the business not being transferred. Thus, E&Y essentially calculated the value of the whole CarMax business and then subtracted the value of the company's various components until only the "residual" value of the car-related IP remained.

A weakness of the DRCF method is its reliance on assumptions to forecast free cash flows. However, E&Y believed this weakness was mitigated "to a considerable degree." E&Y validated CarMax's internal projections to their satisfaction such that E&Y determined its estimate could "be considered reliable."

Initially, E&Y estimated and eliminated the value of the CAF-related business and cash flows from the value of the whole business to arrive at value of \$2,744 million. Then, E&Y eliminated the value of the net working capital,³⁴ the PPE,³⁵ and the retail store leases associated with the business (\$374 million, \$367 million, and \$7 million respectively). After these values were eliminated, the residual value attributed to the car-related IP was approximately \$1.996 million.³⁶

E&Y corroborated its result by calculating the value of the company as a whole using the Market Capitalization (MC) method. This method valued the company based upon the value of the company's stock minus its liabilities. The variability of stock prices lessens the reliability of this method. Nevertheless, E&Y found the value of the company as calculated by the two methods

³³ E&Y rejected the CUT method because there were no sufficiently similar uncontrolled transactions from which to ascertain an arm's length transfer price. E&Y stated: "Given the highly specific, if not unique, character of CarMax's relevant intangibles, it is difficult if not impossible to identify external comparables which could serve as the basis for this analysis." They further determined "[a]lthough there are external examples of some portion of the intangibles being licensed, such as the trademark, E&Y was unable to identify any publicly available external agreements/transactions that involved the sale or license of intangibles similar to all of the intangibles being transferred as part of this transaction." Similarly, E&Y rejected the CMP and PSM for lack of suitably comparable royalty agreements in uncontrolled transactions to use as benchmarks.

³⁴ Net working capital represents the difference between a company's assets and liabilities.

³⁵ PPE refers to a company's property, plants, and equipment.

³⁶ E&Y did not determine what portion of the \$1.996 million was attributable to the IP versus the business process intangibles. However, the relative value of the IP and the business process intangibles was determined for the purposes of the MMSA, which I will discuss in detail below. Based upon the valuations calculated for the MMSA, the IP represents a small fraction of the \$1.996 million figure E&Y calculated. Therefore, most of the value is derived from the business process intangibles.

was very similar (\$3.017 million under DRCF and \$2.932 million under MC). This similarity, in E&Y's opinion, gave credibility to its valuation of the car-related IP under the DRCF method.

Dr. Cody's Opinion

Dr. Cody did not give an opinion on E&Y's 2004 valuation study because he did not feel qualified to do so. Even though he has worked with intangibles and has valuation experience, E&Y's methodology and adjustments were beyond the scope of what he would normally do as a transfer pricing professional. According to Dr. Cody, transfer pricing teams include valuation experts who have specific training in accounting and financial statement analysis compared to economists. Therefore, he would have sought the advice of a valuation expert on his team to assess E&Y's study.

Dr. DeRamus's Opinion

Dr. DeRamus found the DRCF method to be unreliable in this instance because a large portion of the data that was used to value the intangibles was internal and forecasted data. He also questioned whether the residual cash flow should have been attributed to the business process intangibles or whether economies of scale or some other intangible was driving the value. Further, in his opinion, E&Y did not allocate enough of the residual cash flow to the CAF function, which would significantly decrease the value of the business process intangibles.

Although Dr. DeRamus's testimony suggested E&Y's method over-valued the business process intangibles, he also observed that the business process intangibles were one of the most valuable parts of the business according to CarMax's own valuation of them for the purpose of calculating the Management Fee. Because the business process intangibles were so valuable, he found their transfer from CarMax East to CarMax West for zero compensation during the restructuring was not an arm's length transaction. Dr. DeRamus explained that based upon the valuation of the business intangibles at \$1.996 billion,³⁷ he would have expected CarMax West to pay CarMax East this amount in exchange for receiving the business intangibles, but it did not.

Finally, Dr. DeRamus discussed three approaches to valuing partnership contributions. First, under the cost-sharing approach, he would have expected CarMax East to receive a 75% interest in CBS based upon revenue. Under the second approach, based on cash contributions, Dr. DeRamus estimated CarMax East contributed about 90% of the cash value to the partnership and

³⁷ The Court notes that this value also includes the CarMax IP.

would receive commensurate ownership interest. Third, based upon the contribution of tangible assets, Dr. DeRamus opined that CarMax East owned all the tangible assets the day before the restructuring and would have received a nearly 100% interest in CBS. Dr. DeRamus did not conduct a formal analysis to determine an arm's length valuation of the business process intangibles based upon any of the methods he suggested. Nevertheless, in his opinion, he had sufficient information to conclude the ownership percentages in CBS were not arm's length.

Conclusion

At the beginning of this section, I began with two questions: (1) whether the value assigned to the IP and the business process intangibles was correct and (2) whether CarMax East, instead of CarMax West, should have received credit for contributing the IP and the business process intangibles to CBS. Based upon E&Y's Valuation Study, CarMax's valuation of the partnership contributions, and the experts' opinions, I make two conclusions.

First, the evidence was insufficient to establish whether the "car-related IP" was correctly valued. Dr. DeRamus's concerns about forecasted data are reflected in the 482 Regulations, which caution against using internal company data and forecasted data because it can be less reliable. 26 C.F.R. § 1.482-4(d) ("[I]n accordance with § 1.482-1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used."). Here, E&Y relied heavily on internal company data and forecasting that I found questionable, and then relied on notoriously unreliable stock market data to corroborate its results. Therefore, while the **reliability** of the study is diminished, I cannot necessarily say it was incorrect.

Regardless of whether the business process intangibles were correctly valued, a preponderance of the evidence showed they were the most valuable item contributed to CBS. Moreover, it was CarMax West's contribution of the business process intangibles that supported its 93.5% ownership interest in CBS. However, based upon the evidence before me, I conclude CarMax West should not have received credit for their contribution to CBS. CarMax East transferred the business process intangibles to CarMax West for zero compensation in a non-arm's length transaction. 26 C.F.R. § 1.482-1(b)(1) ("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same

circumstances (arm’s length result).”). If CarMax East was in an open market, it would have never given away its very valuable business process intangibles for zero compensation and then agreed to pay a large fee for the use of those same intangibles through the MMSA. *See id.* Rather, CarMax East would have evaluated its reasonable alternatives, including retaining the business process intangibles or selling them for an arm’s length price. 26 C.F.R. § 1.482-1(f)(2)(ii)(A) (providing “the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances” and adjust the consideration charged accordingly).

Because I find the transfer of the intangibles from CarMax East to CarMax West was not an arm’s length transaction, I further find the valuable contribution of the business process intangibles to CBS should be re-allocated to CarMax East. *See* 26 C.F.R. § 1.482-1(a)(2) (“The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations).”); *see also* 26 C.F.R. § 1.704-1(b)(1)(iii) (Westlaw through 89 F.R. 51276) (providing that a partnership “allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482”); 26 C.F.R. § 1.704-1 (Example 28). Unfortunately, there is insufficient evidence to re-allocate the value of CarMax East’s contributions to the partnership. In fact, even if I were to assume E&Y’s Valuation Study is accurate and reliable, E&Y valued the IP and the business process intangibles as a bundle. Thus, the Court cannot separate the value of the business process intangibles from the IP for the purpose of re-allocating the value of the business process intangibles to CarMax East and re-calculating ownership percentages to reflect that value.

Management Fee

The Department contends the Management Fee improperly siphoned income from CarMax East to CarMax West. To defend its Management Fee, CarMax presented two transfer pricing studies that E&Y completed in 2012 and 2015.³⁸

³⁸ CarMax has transfer pricing studies completed every three years. Here, the 2012 transfer study was the more in-depth study. Although annual updates are not required, it is common for companies to conduct transfer pricing studies around every three years after an initial planning study is completed because an intercompany transaction is added. How frequently studies are completed depends on whether the business changes and what risks management is willing

CarMax's Calculation of the Management Fee

The first year of the audit, CBS utilized the 2012 study and charged a Management Fee of \$1,107 per vehicle.³⁹ The second two years of the audit, it used the 2015 study and charged \$1,192 per vehicle. CBS invoiced CarMax West and CarMax East for the Management Fee every month, initially based upon a budget perspective. Then, the fee was trued-up to actual sales and costs on a monthly basis.

CarMax calculated the Management Fee based upon nine components, some of which were calculated as a percent of sales and some of which were calculated based upon cost plus markup. The nine components and the Management Fee, and the rate charged for those components during the audit years, were as follows:

	FY2016 Rate	FY2017 Rate	FY2018 Rate
Value Added Services (% of Sales)			
Advertising and Marketing Services Fee	2.00%	2.00%	2.08%
Intellectual Property License Fee (Trade Names and Intangibles)	0.50%	0.50%	1.50%
Value Added Services (Per Car Range)			
Analytical and Business Development Service Fee	\$413	\$506	\$508
General Support Services (Cost Plus)			
General Management and Administrative Support Services Fee	6.70%	7.90%	7.90%
Human Resources Services Fee	6.70%	7.90%	7.90%
Finance and Accounting Services Fee	6.70%	7.90%	7.90%
Real Estate Services Fee	8.90%	10.40%	10.40%
Legal Services	6.70%	7.90%	7.90%
Management Information Services Fee	6.70%	7.90%	7.90%

See Joint Exhibit 37.

All the fees in this chart were derived from the E&Y transfer pricing studies and represented CarMax's chosen value from an arm's length range. For example, based upon the 2015

to undertake. The 482 Regulations reflect this—if intercompany transactions are a major part of a company's business, then they represent a higher risk for issues and thus merit more frequent and thoughtful studies, whereas one relatively minor intercompany transaction may not merit much investment in studies.

³⁹ In addition to the transfer pricing studies, CarMax also utilized budgeted sales projections and department budgets to estimate the Management Fee on a per vehicle basis for all tax years at issue.

study (FY2017), CarMax chose to impose the median of the arm's length range, which was 2%.⁴⁰ Accordingly, it multiplied its projected sales by 2% to arrive at a fee. However, to reach a per vehicle Advertising and Marketing Services Fee, 2% of projected sales was then divided by the FY2017 units to be sold. The per vehicle Advertising and Marketing Services Fee, \$404 in FY2017, was then aggregated with the other calculated per vehicle service fees to arrive at the total Management fee of \$1,192 for FY2017. A breakdown of the Management Fee for FY2017 is provided below:

FY2017			
Transaction	Arm's Length Range	Rate Used	Markup Per Vehicle Sold
1. IP and Business Process Intangibles	0.5% to 1.3% of sales, median of 0.6%	0.50%	\$101
2. Corporate Management	4.4% to 12.5% markup on cost, median of 7.9%	7.90%	\$178
3. Advertising and Marketing	2.0% to 5.0% of sales, median of 2.0%	2.00%	\$404
4. Real Estate	8.0% to 11.9% markup on cost, median of 10.4%	10.40%	\$3
5. Quantitative Analytics	\$491.00 to \$736.50 per vehicle sold	\$506	\$506
Total Management Fee			\$1,192

E&Y Transfer Pricing Studies

The E&Y transfer pricing studies from 2012 and 2015 are substantially similar in their approaches and conclusions.⁴¹ The studies divide the Management Fee into five separate intercompany transactions (Transactions 1-5), which were priced separately.⁴² The five individual

⁴⁰ If the total per vehicle Management Fee changes very little from one year to the next, then CarMax may adjust one of the rates to keep the per vehicle charge the same for administrative ease for the invoicing department. This is why the percent sales rate for the Advertising and Marketing Services Fee changed from 2.0% to 2.08% from 2017 to 2018. When CarMax adjusts the rate, they do so within the arm's length range of the applicable transfer study.

⁴¹ In the experts' analyses of these studies, they focused on the 2015 study, upon which I also center my analysis.

⁴² Dr. DeRamus asserted the studies should have included a sixth transaction representing the value added to CAF financing transactions by the local stores. In his opinion, the stores should have received origination fees for brining in the customers for the loans, even if CarMax East and CarMax West did not execute the financing. He estimated the origination fee would be about \$314 based upon some documentation he saw from CarMax. Nonetheless, he did not know how this number was calculated, although he considered it a "lower bound" on what would be charged for an origination fee.

transfer prices were then combined, by CarMax, into a single Management Fee per car (as demonstrated in the chart above). Transaction 1 isolated the value attributable to CBS licensing the trademarks, tradenames, and business intangibles to CarMax East and CarMax West. Transaction 2 isolated the value of CBS's corporate management services. Transaction 3 isolated the value of CBS's advertising and marketing services. Transaction 4 isolated the value of CBS's real estate services. Transaction 5 isolated the value of CBS's data analytics and business strategy services (also described as business process intangibles).

Functional Analysis

Before I discuss the five transactions priced by E&Y, it is helpful to first understand the experts' functional analyses of CBS and its relationship to the Group. The experts' functional analyses necessarily guided their opinions on whether E&Y chose the best methods in their studies and whether E&Y's results were reliable.⁴³

Dr. Cody determined CarMax East's and CarMax West's primary function was to execute sales in accordance with any processes established by CBS. He further determined CBS had three primary functions: (1) business strategy and the tools and systems associated with it; (2) financing through CAF; and (3) administrative headquarters functions. Dr. Cody further opined that because of the uniqueness of each used car sold by CarMax, economies of scale was not a large value driver in the context of CarMax's purchase of inventory.

In their studies, E&Y included a specific disclaimer that they did not consider, or price, an intercompany transaction for the CAF transaction because it was outside the scope of what they were contracted to do. Nevertheless, I find an origination fee was appropriate. However, there was insufficient evidence to show what amount should have been charged for the origination fee. CarMax's failure to assign a transfer price to the CAF transaction, or otherwise account for a loan origination fee, means that CarMax East paid more in Management Fees than it should have. In other words, the Management Fee should have been reduced by some amount to compensate CarMax East for originating loans, including South Carolina loans. Because it was not, the Management Fee siphoned some amount of income from CarMax East to CarMax West that should have been retained by CarMax East for the origination fees. As a result, CarMax East's taxable income was also reduced.

⁴³ The functional analyses presented by the parties were more akin to overall analyses of CarMax's business and what drives value in the business. However, functional analyses under the 482 Regulations are much more specific to the transaction being evaluated because the goal of the functional analysis is to gauge the similarity of comparable uncontrolled transactions. *See* 26 C.F.R. § 1.482-1(d)(3)(i) ("Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction."). Therefore, while this general understanding of CarMax's functions and value drivers provides context, each discrete transaction requires its own functional analysis to determine whether sufficiently similar comparables exist to benchmark a particular transaction using a particular method under the 482 Regulations. *See id.*

Dr. DeRamus disagreed with Dr. Cody's characterization of the role the local stores play as mere executors of CBS's business strategies. In his opinion, the local stores drove value for the business because the local stores bought inventory, reconditioned the cars, sold the cars, and interacted with customers.

Also in contrast to Dr. Cody, Dr. DeRamus ascribed much of CarMax's competitive advantages to its economies of scale. He asserted that because the CarMax Group is a national chain, it was able to provide its customers with a selection of vehicles that most used car dealers could not. Dr. DeRamus further asserted that CarMax's economies of scales gave it (1) an informational advantage for collecting data on what cars to sell and where and when to sell them, and (2) allowed it to spread costs, including its reconditioning costs, over more sales.

I found Dr. Cody too easily dismissed economies of scale as a competitive advantage and value driver. While CarMax is in the business of buying unique items, CarMax still benefits from its large size in several ways, including the selection it offers to customers and its ability to spread costs. However, I also find that Dr. DeRamus minimized the impact of CBS's strategic involvement when he determined the local stores created almost all value for the business. While it is true that the actual sale of the car, the largest value generator, happens at the local store, many strategic decisions underlay that sale—the price CarMax pays for its cars at auction or in the appraisal lane; the decision about what to recondition; the price at which to sell the car—were influenced, if not governed, by CBS's systems and processes.⁴⁴ Indeed, while the sales themselves created profit, the systems increased the margin of that profit.

Overall, I find the local stores, through the actual sales of cars and the employees' input as to the condition of the cars purchased, created the most revenue for CarMax. Nonetheless, I recognize that CarMax's gross profit margins were enhanced by CBS's proprietary systems. CBS's systems assisted local stores in making decisions about how to price cars, what cars to buy and how much to pay for the cars, and when and how to recondition cars. Still, I was unconvinced that these systems create more value than the employees and the local stores themselves who actually make and execute the decisions leading to sales. Moreover, CarMax benefitted from economies of scale. Its size and nationwide presence made it a formidable competitor in an otherwise fractured

⁴⁴ Dr. DeRamus acknowledged that savings in the reconditioning process add up to "significant dollars" but attributed the value generation to the local stores performing the reconditioning rather than CBS's process for when and how to recondition.

used car market with mostly smaller, independent sellers. I further find that CarMax's reputation for quality, low-mileage used cars, its national selection, no-haggle pricing, customer-friendly service, and financing availability also drove value for the company. With this analysis in mind, I turn to the transactions at issue.

Transaction 1

Transaction 1 priced the value of CBS's IP and its business process intangibles that were established systems.⁴⁵ E&Y selected the comparable uncontrolled transaction (CUT) method to price this transaction, which is one of the methods specified for the pricing of intangibles under the 482 Regulations. 26 C.F.R. § 1.482-4(c). Ironically, E&Y rejected this method in its 2004 Valuation Study when it valued the company's IP and business process intangibles. In that study, E&Y rejected CUT because it determined there were no companies with sufficiently similar comparable intangibles due to CarMax's unique combination of intangibles.

The CUT method "evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction." *Id.* The 482 Regulations describe its application as follows:

If an uncontrolled transaction involves the transfer of the **same intangible** under the **same, or substantially the same, circumstances** as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Circumstances between the controlled and uncontrolled transactions will be **considered substantially the same if there are at most only minor differences** that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of **comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.**

26 C.F.R. § 1.482-4(c)(2)(ii) (emphasis added). Thus, the CUT method generally requires a very high degree of comparability to be reliable.

⁴⁵ E&Y separated the business process intangibles into two kinds: systems and strategies. Some business process intangibles were also defined as both a system and a strategy. Only the business process intangibles that were "systems" were valued in Transaction 1. How this distinction was made and how the two kinds of intangibles were valued will be explained further under Transaction 5. However, the reason for the distinction was never sufficiently explained. In Dr. DeRamus's opinion, all the business process intangibles should have been valued together. Indeed, separating the intangibles into two kinds only seems to add confusion and decrease the reliability of E&Y's results because valuing the distinction relied upon educated estimations rather than concrete numbers.

To determine the comparability of a controlled and uncontrolled transaction, the analyst should assess the specific factors listed in § 1.482-1(d): functions; contractual terms; risks; economic conditions; and property or services. 26 C.F.R. § 1.482-4(c)(2)(iii)(A). Additionally, a comparability analysis under CUT must also consider whether the uncontrolled transaction is “used in connection with similar products or processes within the same general industry or market” and “have similar profit potential.” § 1.482-4(c)(2)(iii)(B)(1).

Furthermore, “[i]n evaluating the comparability of the circumstances of the controlled and uncontrolled transactions the following factors “may be particularly relevant”: (1) the terms of the transfer; (2) the stage of development of the intangible; (3) rights to receive updates, revisions, or modifications of the intangible; (4) the uniqueness of the property; (5) the duration of the license; (6) any economic and product liability risks; (7) the existence and extent of any collateral transactions or ongoing business relationships; (8) the functions to be performed by the transferor and transferee; and (9) the accuracy of the data and the reliability of assumptions used. § 1.482-4(c)(2)(iii)(B)(2).

E&Y determined the CUT method was the best method because it found uncontrolled transactions it deemed sufficiently comparable to support this method. The uncontrolled transactions it utilized were the licensing components of franchise agreements from the retail industry. E&Y chose franchise agreements from within the automotive industry (new car dealers, used car dealers, automotive parts dealers, tire dealers). They then narrowed their search further by eliminating franchise agreements that dealt with lump sum transfers for IP, agreements that were not licensing agreements, or agreements pertaining to an unlike industry. In total, they identified eleven acceptable franchise agreements. These agreements primarily came from oil change companies and tire service companies; none were car dealers.

The franchise agreements selected by E&Y included some bundled valuables that were not present in Transaction 1, including general corporate support and assistance with real estate. To avoid including compensation for the corporate support services in their valuation, E&Y quantified the value of the additional services and subtracted them from the franchise fees so that the only part of the franchise agreements being valued were the trademarks, tradenames, and business process intangibles. To quantify and exclude the corporate support services, E&Y looked at a specific type of franchise relationship to isolate the price of the intangibles in the franchise agreements—the relationship between a master franchisor, a master franchisee, and a franchisee.

The proportion of the total royalty rate paid by the franchisee that was remitted to the master franchisor by the master franchisee was utilized to determine the royalty rates that master franchisees would remit to the master franchisor for trademarks, trade names, and business process intangibles. Based upon this analysis, E&Y then concluded, in 2015, the arm's length range for the Transaction 1 was 0.5% to 1.3% with a median of 0.60%.

The experts disagreed about whether E&Y's methodology was the best method and reliable. In Dr. Cody's opinion, E&Y conducted a thorough and diligent analysis of Transaction 1 and he agreed with their selection of CUT as the best method. Additionally, he found E&Y's use of franchise agreements and the adjustments they made to those comparables were reasonable, and their process comported with how he has developed transfer pricing studies in retail over the past twenty years.

In contrast, Dr. DeRamus found E&Y's handling of Transaction 1 was unreliable. He criticized E&Y's selection of the CUT method, which, according to his understanding, should only be used when very similar uncontrolled transactions that do not need to be adjusted to account for a variable. Dr. DeRamus explained that franchise agreements are very different from trademark license agreements, and E&Y should have used "actual royalty agreements for the use of the trademark." He further explained that "you rarely find observations, reliable observations of trademarks licenses" in the retail setting because the value in most scenarios is close to zero. He also criticized E&Y for bundling some of the business process intangibles into Transaction 1 instead of simply accounting for all the business process intangibles in Transaction 5.

I find Dr. DeRamus's criticism of E&Y's choice of the CUT method is supported by the 482 Regulations. As the 482 Regulations instruct, the CUT method is appropriate where there are comparables involving "the **same intangible under the same, or substantially the same, circumstances** as the controlled transaction." 26 C.F.R. § 1.482-4(c)(2)(ii). CBS was compensated under a licensing agreement, not a franchise agreement. Additionally, the franchise agreements utilized by E&Y compensated the franchisor for a broader set of intangibles than the licensing fee compensates CBS for. Generally, CUT requires a very rigorous evaluation of the comparability of the controlled and uncontrolled transactions, which was not present here.⁴⁶ See § 1.482-1(d); § 1.482-4(c)(2)(iii)(B)(1); § 1.482-4(c)(2)(iii)(B)(2).

⁴⁶ E&Y's analysis fails under the general guidelines for applying CUT without further evaluation of comparability under the 482 Regulations, including whether the comparable companies selected by E&Y had similar functions,

Moreover, the industry from which these franchise agreements originated was a very limited sub-part of the broader automotive services industry—namely, oil change servicers, tires servicers, and a couple franchise agreements for motorcycle dealers. The intangibles at issue in this case deal with the sale of used cars and some ancillary automotive services. Thus, the intangibles at issue are not the same, the industry is not the same, and the circumstances of the transaction are not the same. *See* § 1.482-4(c)(2)(ii). Indeed, E&Y’s application of CUT is undermined by its own determination that this method was not the best method for an almost identical set of intangibles when it conducted its 2004 Valuation Study. It rejected CUT then for lack of sufficient comparables.

Further, the degree of dissimilarity between CBS’s licensing agreement and the franchise agreements E&Y used is large enough that I do not find E&Y’s attempt to account for the dissimilarity to comport with the 482 Regulations’ allowance for “only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made.” § 1.482-4(c)(2)(ii); *see also, e.g., Medtronic, Inc. & Consol. Subsidiaries v. Comm’r of Internal Revenue*, 124 T.C.M. (CCH) 69 (T.C. 2022) (observing that too many adjustments can result in CUT not being the best method). These were not minor differences; E&Y had to go through a fairly extensive process to isolate the value of the intangibles in the franchise agreements using a further level of comparison with master franchisor agreements. *See* § 1.482-4(c)(2)(ii). The reliability of their results was, thus, significantly reduced. *See* 26 C.F.R. § 1.482-4(c)(ii) (“[U]ncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.”).⁴⁷

Based upon the above, I find CUT was not the best method. 26 C.F.R. § 1.482-1(c).

contractual terms, risks, economic conditions, and property and services. 26 C.F.R. § 1.482-1(d)(1). Moreover, E&Y did not include an analysis of how the companies used these franchise agreements “in connection with similar products or processes within the same general industry or market” and “have similar profit potential.” § 1.482-4(c)(2)(iii)(B).

⁴⁷ Based upon the Record, and to this Court’s knowledge, E&Y did not include copies of the franchise agreements with their analysis or provide a functional analysis or a comparability analysis to justify use of their eleven chosen agreements as sufficiently comparable under the 482 Regulations’ comparability standards. *See* § 1.482-1(d); § 1.482-4(c)(2)(ii). Dr. DeRamus found the failure to include the underlying franchise agreements to be a “major deficiency.” Indeed, without the underlying agreements, which were not supplied by any party, it is impossible for this Court to vet E&Y’s analysis under the 482 Regulations to the degree required had the franchise agreements been appropriate to begin with. However, because I find the comparison of this transaction to franchise agreements is inappropriate under the CUT method, I do not need to venture into that deep of an analysis.

Next, although I find CUT was not the best method, I am not persuaded by Dr. DeRamus's arguments that the IP, in retail settings, has almost no value. In fact, Dr. DeRamus admitted that the goodwill associated with the brand and the customer's experience can add considerable value to a company. Further, he seemed to agree that if a third party owned the CarMax trademarks and tradenames, the value would not be zero.⁴⁸

Overall, I find E&Y's application of the CUT method to Transaction 1 does not comport with the 482 Regulations and is not reliable. Since E&Y's calculation of the transfer price for Transaction 1 is unreliable, I find that CarMax's adoption of a transfer price for Transaction 1 that falls within E&Y's calculated range is also unreliable. Finally, while I find the IP has value, I do not find it is a uniquely valuable asset. CarMax does not own a patented drug; it has a reputation and goodwill under its brand. Therefore, CBS's compensation for the IP should be modest.

Transaction 2

Transaction 2 valued the back-office corporate support services CBS provided to CarMax East and CarMax West. These are ordinarily considered less valuable services. To benchmark this transaction, E&Y used the comparable profits method (CPM). The CPM "evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators or "PLI") derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances." 26 C.F.R. § 1.482-5. E&Y chose operating profits as a percent of total cost as the PLI. E&Y calculated an arm's length range of between 4.4% to 12.5% markup on total costs with a median of 7.9%.

According to Dr. Cody, E&Y selected a standard set of comparables for this type of transaction, and the calculated arm's length range was consistent with Dr. Cody's expectations. DeRamus agreed with the use of CPM method and its outcome, even if he quibbled slightly with the comparables.⁴⁹

⁴⁸ I also find that while the value of the IP was developed by CarMax before CBS was created, CBS has since contributed to the value of the trademarks by assuming the risk associated with preserving them.

⁴⁹ Although Dr. DeRamus agreed CPM was a reasonable method for this transaction, because the ownership interests in CBS are not arm's length, he noted that CPM would not produce an arm's length result. To correct the effect of the partnership distributions, Dr. DeRamus suggested the service cost method (SCM) should be applied to Transaction 2. Under the SCM, the transfer price is essentially equal to cost with no markup (profits are eliminated). See 26 C.F.R. § 1.482-9(b) ("The services cost method evaluates whether the amount charged for certain services is arm's length by reference to the total services costs (as defined in paragraph (j) of this section) with no markup."). By eliminating profits in this case, SCM would prevent CBS from receiving profit that would then be redistributed through the partnership, thus limiting the effect of the partnership distributions on CarMax East's and CarMax West's taxable

I conclude the E&Y transfer price for Transaction 2 was reasonable and reliable. CPM is commonly used to price the services covered by this transaction and both experts agreed the method, comparables, and results were reasonable.

Transaction 3

Transaction 3 valued the advertising and marketing services. E&Y chose the comparable uncontrolled services price method (CUSP). CUSP is identical to the CUT method except that it is adapted for services. CUSP “evaluates whether the amount charged in a controlled services transaction is arm’s length by reference to the amount charged in a comparable uncontrolled services transaction.” 26 C.F.R. § 1.482-9(c) (Westlaw through 89 F.R. 51276). Like CUT, CUSP requires a high degree of similarity between the controlled and uncontrolled transactions to be reliable. With regard to comparability, the 482 Regulations provide that not only must the functions, contractual terms, risks, economic conditions, and property or services of the transactions be considered, but similarity of the services rendered and of the intangible property used in performing the services (if any) is very important. § 1.482-9(c)(2)(iii). Moreover,

because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled services price method generally will be the most direct and reliable measure of an arm’s length price for the controlled transaction if an uncontrolled transaction has no differences from the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled

income. Indeed, Dr. DeRamus suggested the SCM should be used for all the Management Fee transactions to reduce the Management Fee to cost. I find Dr. DeRamus’s opinion to be problematic.

First, whether the partnership distributions are correct is an important issue in this case that can, and should, be dealt with separately from the discrete transactions priced in the Management Fee, which may very well be arm’s length themselves. Dr. DeRamus was essentially suggesting that the Management Fee be adjusted to correct a distortion in the partnership distributions. Yet, Dr. DeRamus provided no authority under the 482 Regulations for applying them in this way.

Second, the SCM is elected by the taxpayer and cannot be imposed by the IRS or the Department in this case. Moreover, the SCM may only be elected under very specific circumstances, and most of the Management Fee transactions would not qualify for its use. *See* 26 C.F.R. § 1.482-9(b)(2)(i)-(iv) (describing the qualifying circumstances). E&Y’s 2015 study specifically rejects SCM because CarMax elected a markup on total costs for the services provided under Transaction 2.

Therefore, I reject Dr. DeRamus’s assertion that SCM should be used for this transaction, or any other transaction within the Management Fee, to achieve a more arm’s length result in light of, and correcting for, the partnership distributions.

transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, **if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.**

26 C.F.R. § 1.482-9(c)(2)(ii) (emphasis added).

According to the 2015 Transfer Pricing Study, E&Y chose CUSP over CPM because the advertising fees in the franchise agreements it selected for Transaction 1 were sufficiently similar to be more reliable than finding comparables for the CPM. Specifically, E&Y could not "identify any parties providing services to CarMax Stores similar to the services being provided by [CBS]." Thus, for comparables, E&Y returned to the franchise agreements it selected for Transaction 1 and identified eight agreements that contained separate compensation for advertising services similar to those provided by CBS. Based upon these comparables, E&Y determined the arm's length range for advertising fees as a percentage of sales was between 2.0% and 5.0% with a median of 2.0%.

Dr. Cody found E&Y's choice of the CUSP method and their use of franchise agreements to be reasonable and appropriate based upon his experience. He explained it is common for a retailer to have a centralized advertising and marketing component that incurs expenses, which are then reimbursed by the individual retail operations that benefit.⁵⁰ The local store may conduct some of its own advertising while also benefiting from the national website or national commercials that bring customers into the local store.

Dr. Cody further explained that franchises typically charge an advertising fee for the value of their advertising services. And, because CarMax's business is set up parallel to a franchise, Dr. Cody thought using the franchise agreement comparables from Transaction 1 was appropriate. Additionally, Dr. Cody asserted the fee is usually expressed at a percent of revenue of the retailer, which is what E&Y did for CarMax. Dr. Cody also found CarMax's decision to impose a 2% fee aligned with industry comparables.

⁵⁰ There was evidence, according to Dr. DeRamus, that CarMax East and CarMax West were expending a substantial amount of the advertising costs in the first instance and were reimbursed by CBS, which then allocated the costs to itself. Specifically, based upon CarMax's accounting records, Dr. DeRamus calculated CarMax East had a total of \$96,558,867 in advertising expenses, CarMax West had \$41,485,393 in advertising expenses, and CBS had \$20,508,087 in advertising expenses in the first instance. Thereafter, CBS picked up the advertising expenses for the Group such that it incurred \$132,806,425 in expenses. Whether the costs initially incurred by CarMax East and CarMax West reflected their own development of advertising and strategies, or simply reflected the costs of implementing strategies and campaigns developed by CBS, was unclear. However, the evidence generally showed that CBS developed most of the advertising and marketing for the local stores.

Dr. DeRamus disagreed with E&Y's choice of CUSP, which he found to be inconsistent with the 482 Regulations and unreliable. Dr. DeRamus explained the CUSP method requires "very, very close comparability," if not identical, and E&Y used advertising fees for franchises, which CarMax is not. He also criticized E&Y and CarMax, again, for not providing a copy of the franchise agreements underlying the studies.

With regards to the outcome of E&Y's application of CUSP, Dr. DeRamus found that it was "on its face patently unreasonable" because CBS was charging a 2% fee for something that cost 1% to provide. He calculated the 2% advertising fee to equate to a markup on total costs of 113.1% to 115.5% over the audit years.

Instead of CUSP, Dr. DeRamus would have applied the CPM. When he used CPM to benchmark advertising services companies, he concluded the arm's length range for a markup on total costs was 4.4% to 8.9% over the audit years with an average of 8.3%.

Similar to my findings in Transaction 1, I conclude that CUSP was not the best method for this transaction and is unreliable pursuant to the 482 Regulations. Indeed, CUSP requires a high degree of comparability. Like in Transaction 1, I conclude that advertising under a franchise agreement is not sufficiently similar to CBS's provision of advertising services. CarMax is not a franchise, even if it may be similar in some ways. Neither E&Y's study nor Dr. Cody explained to a sufficient degree of detail how CBS and a franchise are comparable in their functions, contractual terms, risks, economic conditions, and property or services of the transactions. § 1.482-9(c)(2)(iii). As the 482 Regulations discuss, "even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences." § 1.482-9(c)(2)(iii). Without the underlying franchise agreements available for review, differences in contractual terms or economic conditions cannot be ascertained, and the similarity of these franchise agreements cannot be shown or vetted.⁵¹

⁵¹ Of note, CBS was contracting with Horizon Media to provide advertising services during the audit years. The contract with Horizon Media would thus appear to be an uncontrolled transaction to utilize under the CUSP method because it is a contract between CBS and a third party that would provide a high degree of similarity. Why this transaction was not utilized was not sufficiently explained.

Transaction 4

Transaction 4 valued the real estate services provided by CBS to CarMax East and CarMax West. The services performed by CBS included site selection, property acquisition and negotiations, negotiations of leases, market research around site selection, and other ancillary services. E&Y used CPM to benchmark the price for this service based on the markup on total costs (MTC). In their 2015 study, E&Y found comparable companies that performed real estate services and determined the arm's length range was 8.0% to 11.9% with a median of 10.4%.

Dr. Cody explained that, like the back-office services in Transaction 2, the real estate services provided in Transaction 4 are very straight-forward and common. He determined E&Y's method and results were reasonable and reliable. Similarly, Dr. DeRamus determined E&Y selected the best method for this transaction, and, similar to Transaction 2, while he would quibble with some of the specific comparables, they "appeared to be broadly reasonable."

I find CPM was a reasonable and reliable method for this transaction. I further find that CarMax's transfer price for this transaction, which was based upon E&Y's study, is reasonable and reliable.

Transaction 5

Transaction 5 valued the analytical and business development services (quantitative analytics), including the related business process intangibles. To benchmark this function, E&Y used an unspecified method (UM)⁵² because "transaction based comparables were not available and a traditional cost-base analysis would not reflect the value being driven for CarMax Stores through the analytical and business developments services." In its 2015 transfer pricing study, E&Y found:

The analytical and business development services provided by [CBS] are proprietary and directly relate to CarMax Stores competitive position in the market place. The services are primarily provided by [CBS]'s Quantitative and Analytics group. Because of the unique and proprietary nature of these services, transaction-based comparables were not available and a cost based approach was not deemed to be appropriate.

Thus, [CBS] determined the value being delivered through these services. The value being delivered can be traced through either cost savings or revenue generation. Appendix 8 summarizes the cost savings and revenue generated for the

⁵² Unspecified methods are recognized methods under the 482 Regulations. *See, e.g.*, § 1.482-9(h).

various business strategies and systems developed by this group. The total value calculates to \$1,526.50 per vehicle.

Thus, the data used to calculate the transfer price for Transaction 5 came directly from CarMax and CBS. Appendix 8 to E&Y's 2015 study contains a list of cost savings or revenue-generating systems and strategies or "both" (the item was both a system and a strategy). Each system/strategy was assigned a value per car in Appendix 8 that was generated from CarMax's internal data.

According to Dr. Cody, systems are tools that have already been rolled out and are in place—these systems equate to the business process intangibles from Transaction 1. Strategies, in contrast, are newer systems that are currently in development or decisions about how to use tools operationally that will have an effect on CarMax's overall business strategy and competitiveness. Dr. Cody stated the decision tree CBS developed regarding when and how to paint a car was a system, and how to take advantage of the additional margin created by the system was a strategy. He also explained systems and strategies can overlap. In Transaction 5, E&Y was attempting to value the strategies. The systems, in contrast, were purportedly valued in Transaction 1.

E&Y determined there was overlap between the value of the "systems" (aka business process intangibles) that were lumped into Transaction 1 and the strategies being valued in Transaction 5. To avoid double-counting, E&Y eliminated the systems-related value that was already priced in Transaction 1, which it estimated to be \$299 based upon the values assigned to these systems in Appendix 8. However, some analytical and business development services involved both systems and strategies that were difficult to parse. Based upon CarMax's estimation that at least 40% and upwards of 60% of its analytical and business development services were systems-driven, E&Y developed a range of value for the remaining business strategies. In 2015, it calculated that between \$491 and \$736.50 per vehicle was attributable to strategies. CarMax chose to impose a \$413, \$506, and \$508 fee per car for Transaction 5 in each audit year, respectively.

In reviewing this transaction, Dr. Cody emphasized the importance of applying a higher level of scrutiny to a transfer price, like this one, that relies exclusively on internal company data with no reference to uncontrolled companies or uncontrolled transactions. In particular, he stressed the need to investigate why the internal data was collected, the circumstances under which it was collected, etc., and these factors all contribute to the data's reliability. Dr. Cody specifically found the CarMax's internal data to be reliable because it was not based upon forecasting, but rather based upon actual tests with proven results—the data went "right to the actual value created by the analytical and business strategy tools that CBS develops and then implements." Overall, Dr. Cody

found E&Y's analysis was reasonable and it comported with his own investigation and analysis of the business analytics' group contributions.

In contrast, Dr. DeRamus found E&Y's application of the UM to be inconsistent with the 482 Regulations because their study did not provide all the data and assumptions underlying the application of the method beyond the figures in Appendix 8. Accordingly, he found their application of this method "not clear at all." Similarly, he criticized the values CarMax and E&Y assigned to Transaction 5—the \$1,526 per car for all systems and strategies and the number they derived for the excluded systems—\$299—as having no discernable basis that he could recalculate and check. According to Dr. DeRamus, the \$1,526 number "just screams out as being unreliable." Dr. DeRamus also asserted that CarMax makes about \$2,156 in gross profit off each car and \$1,526 represents about 70% of that, which Dr. DeRamus found to be absurd on its face for such a small group within the company.

According to Dr. DeRamus, this function was much less valuable than E&Y calculated because selling cars, generally, is what produced profit for the company, and any profit generated by CBS through strategies was much less significant. Dr. DeRamus criticized E&Y's assignment of such a large value to what are, in his opinion, ubiquitous pricing and inventory algorithms that are common functions across large companies and based upon standard technology and use standard methods. In other words, Dr. DeRamus implied that these algorithms are so standard and common that the value is only as good as the data inputs.⁵³

Dr. DeRamus further compared the estimated cost of providing the business and analytics services to the profits earned by this function. Based upon his estimation of CBS's costs, mostly payroll, he estimated the markup on total costs of to be on the order of 4,000% to 5,000%. Dr. DeRamus emphasized that whether the markup up was 1,000% or 5,000%, he could not be sure without more detailed, granular information, but his estimation was sufficient to show that the charge was not arm's length.⁵⁴

⁵³ Although I generally find Dr. DeRamus's opinion more persuasive, I disagree with his complete minimization of the value and impact of CBS's analytical and business development services. The local stores are responsible for the sale of the car which is the main profit driver; nevertheless, strategies to improve margins and reduce costs are an important profit driver, along with the benefits of economies of scale. Moreover, while data systems may be ubiquitous across an industry, they can still have value when the systems are tailored to the company and do a uniquely good job for the company.

⁵⁴ Dr. DeRamus also opined that if CarMax's data analytics group created so much value, CarMax would presumably sell its highly profitable data analytics to other companies and its competitors. On the one hand, this makes sense—be in the business that will make you the most money. However, CarMax said it treats its business process

Overall, it is difficult to analyze whether the E&Y transfer price is reliable or, rather, sufficiently reliable to fall within an arm's length range. The 482 Regulations provide the following guidance for using the unspecified method for a services transaction:

[I]n establishing whether a controlled services transaction achieved an arm's length result, **an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction** (for example, outsourcing a particular service function, rather than performing the function itself). As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482-1(c). Therefore, in accordance with § 1.482-1(d) (comparability), **to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced**. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

26 C.F.R. § 1.482-9(h) (emphasis added).

In theory, as Dr. Cody noted, CarMax's data development regarding its cost-savings and increased margins is sound. CarMax described a very rigorous, on-going testing process that is undertaken independent of any need for transfer pricing data. Therefore, E&Y did not use forecasted data, which both Dr. Cody and the 482 Regulations describe as less reliable. However, the use of rigorously collected, non-forecasted data makes it all the more disappointing that E&Y's study simply takes CarMax at its word without including the underlying data calculations for the figures listed in Appendix 8. The figures in Appendix 8 are clearly summary totals of other calculations, and, while CarMax submitted a spreadsheet with a summary tab (Joint Exhibit 68) that further explains these figures, the explanation is insufficient to explain the genesis of these figures.

Based upon the 482 Regulations, Dr. DeRamus's critique concerning the underlying data is valid. Using internal data that is not sourced from uncontrolled transactions is subject to higher scrutiny under the 482 Regulations. *See* 26 C.F.R. § 1.482-9(h). Here, there is no way to scrutinize the data in Appendix 8 because the underlying calculations are not available. For example, CarMax

intangibles like a trade secret, and I do not find it unreasonable that CarMax would not wish to sell a major source of its success in its industry. Thus, I did not find this argument persuasive.

Similarly, based upon how much value was attributed to the data analytics group, Dr. DeRamus opined that he believed a passive association benefit from CarMax's economies of scale was being lumped into Transaction 5 to add more value when no specific entity within the CarMax Group should get to claim the value of passive association benefits, which is improper in transfer pricing. However, I find no evidence that CarMax added a value for a passive association benefit into its calculation of Transaction 5.

conducted testing related to its reconditioning process, and determined the decision tree they developed for determining whether to paint a car saved them approximately \$150 per vehicle. In Appendix 8, a figure of \$450 is listed for “Waste elimination – recon,” which appears to be shorthand for reconditioning. It is unclear what makes up this figure—presumably, \$150 of that figure is the repainting system. However, because the only data we have to evaluate is Appendix 8, it is impossible to know what other cost-savings make up this figure and how those cost-savings were calculated.

Moreover, as noted by Dr. DeRamus, it is difficult to imagine that these systems and services developed by the business analytics team are responsible for about 70% of the profits CarMax makes on each car. It is even more unlikely that even if the value of these services is not tied to cost, the percent markup on cost would be in the thousands as estimated by Dr. DeRamus. Nevertheless, I disagree with Dr. DeRamus’s assessment that the data analytics services provided by CBS have little to no value above cost. I thus did not find the entirety of Dr. DeRamus’s functional analysis to be reliable or credible based upon his lack of understanding of CBS’s data analytics functions.

Additionally, Dr. Cody explained that the value of this kind of transaction is not tied to cost in the way that some others are. In Dr. Cody’s opinion, the value of the business analytics group is not related to the cost incurred for those activities because the value of the systems being developed continues long after the effort it took to develop and test them stops. Thus, the initial expense to develop the system is not indicative of its value of the course of its lifetime, especially when, as here, CBS continues to modify, improve, and increase the efficacy of those systems to produce more value over time.

Overall, I conclude that E&Y’s use of an UM with internal data that is not capable of being scrutinized renders this method unreliable under the 482 Regulations. *See* 26 C.F.R. §1.482-1(c)(2)(ii) (indicating that an analysis is relatively more reliable as the completeness and accuracy of data increases). Additionally, there was no data or quantitative evidence to support CarMax’s estimation that 40% to 60% of the value of its combined systems and strategies represent the systems-driven value. Nevertheless, I find the business analytics group provides a service of some

value to CarMax that is worth more than a modest markup. What the arm's length price for this function should be was not established by either party.⁵⁵

Overall Reliability of the Management Fee

I conclude the evidence shows the Management Fee, as a whole, is not reliable. As I have discussed, E&Y's methodologies for Transactions 1, 3, and 5 are not reliable. These are the largest value-earning transactions; accordingly, their unreliability has a significant impact on the overall reliability of the Management Fee. Therefore, I conclude the E&Y study transfer pricing studies from 2012 and 2015 do not reliably support the price of the Management Fee. In turn, they do not justify the amount of income being shifted from CarMax East and CarMax West to CBS for its services through the Management Fee.

Further, neither expert provided a reliable, arm's length transfer price for the Management Fee under the 482 Regulations. Without reliable transfer prices for Transactions 1, 3, and 5, it is hard to establish the extent to which the Management Fee may be improperly siphoning income away from CarMax East as the Department asserts.

If this were an ordinary transfer pricing case, the Court would be in a difficult position to try and calculate the correct transfer prices. *See, e.g., Sundstrand Corp. & Subsidiaries v. Comm'r*, 96 T.C. 226, 354 (1991) ("Should petitioner overcome [the Commissioner's] presumption of correctness and prove that the deficiencies set forth in the notice of deficiency are arbitrary, capricious, or unreasonable, but fail to prove that alternative allocations it proposes satisfy the arm's-length standard, the Court must determine from the record the proper allocation of income[.]"). However, while Petitioner has used transfer pricing studies to defend the transfer of income between related parties in this case, the Department has asserted that standard allocation and apportionment does not fairly reflect CarMax's taxable income in South Carolina. Therefore, standard allocation and apportionment is the lens through which I view the unreliability of the Management Fee. Moreover, whether the Management Fee is acting as an improper siphon or not, its income-shifting effect is not nearly as significant as that of the partnership distributions.⁵⁶

⁵⁵ Because I find that Dr. DeRamus had an insufficient understanding of the business analytics group at CBS, I do not find Dr. DeRamus's alternative application of the CPM to Transaction 5 to be reasonable or reliable.

⁵⁶ Importantly, even if the Management Fee is an arm's length price, because of how the partnership distributions are set up, a substantial amount of CarMax East's income will still be shifted to CarMax West. To the extent the Management Fee is excessively high, the effect of the partnership distributions is exacerbated.

Tax Policy Considerations

Professor Richard Pomp testified on behalf of Petitioner. He is currently the Alva P. Loiselle Professor of Law at the University of Connecticut and the Board of Trustees Distinguished Professor. The Court qualified Professor Pomp as an expert in tax policy. Professor Pomp explained that states imposing corporate income taxes generally select one of two different reporting methods, which they require taxpayers to use: (1) separate reporting, or (2) CUR.

According to Professor Pomp, economic development reasons might influence a state to choose separate reporting over CUR. He explained that southern states, which historically had more agriculture-based economies, began using separate reporting to compete with northern states, which had more industrial-based economies and thus had more infrastructure that would be attractive to businesses. Separate reporting can be more attractive to businesses, especially when combined with a single sales factor, because it creates an advantageous tax climate, particularly for companies looking to invest property and payroll in a particular state while selling in other states.

On the other hand, a state might choose to require CUR to address tax minimization strategies. Professor Pomp explained that CUR, if done on a worldwide basis, would undercut tax havens in other countries. Professor Pomp has been a long-standing proponent of CUR, and if this were a legislative hearing, he would recommend that South Carolina adopt CUR.

Professor Pomp also discussed alternative apportionment statutes, Section 18 of UDITPA, and how good tax policy would suggest using these statutes. He explained that alternative apportionment statutes function like a safety valve for unusual circumstances where the standard apportionment method is not working for the particular facts of a taxpayer's business. He believes this is good tax policy because a relief mechanism, like South Carolina's alternative apportionment statute, should not be interpreted so broadly that it swallows up the standard method. Instead, alternative apportionment should be used judiciously such that the default method is predominantly used, and taxpayers' reliance interests are protected.

Finally, Professor Pomp opined that when the alleged tax defect is with a transfer price rather than the apportionment method, the appropriate remedy is to alter the transfer price, not change the taxpayer's reporting method. In his opinion, changing a taxpayer's reporting method in this situation is unwarranted and inconsistent with the purpose of alternative apportionment.

ISSUES

1. Does the Department have authority under subsection 12-6-2320(A)(4) to require CarMax East to use CUR?
2. Does standard allocation and apportionment fairly represent the extent of CarMax East's business activity in South Carolina?
3. Is the application of CUR reasonable and equitable?

CONCLUSIONS OF LAW

Standard of Review

This Court has jurisdiction over this case pursuant to section 12-60-460 of the South Carolina Code (2014) and section 1-23-600 of the South Carolina Code (Supp. 2023).

This is a contested case that is heard *de novo*. *Brown v. S.C. Dep't of Health & Env't Control*, 348 S.C. 507, 512, 560 S.E.2d 410, 413 (2002) (explaining that a contested case before the ALC is “in the nature of a de novo hearing with the presentation of evidence and testimony”). The standard of review is a preponderance of the evidence. S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2023); *see also Anonymous (M-156-90) v. State Bd. of Med. Exam'rs*, 329 S.C. 371, 375-78, 496 S.E.2d 17, 19-20 (1998) (“Absent an allegation of fraud or a statu[t]e or a court rule requiring a higher standard, the standard of proof in administrative hearings is generally a preponderance of the evidence.”). Generally, the party asserting the affirmative issue has the burden of proof. *DIRECTV, Inc. & Subsidiaries v. S.C. Dep't of Revenue*, 421 S.C. 59, 78, 804 S.E.2d 633, 643 (Ct. App. 2017). However, when the Department asserts an alternative apportionment method under section 12-6-2320 of the South Carolina Code, the Department has the burden of proof. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014); *Rent-A-Ctr. W. Inc. v. S.C. Dep't of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016).

The Unitary Business Principle and Combined Reporting

It is undisputed that Petitioner CarMax East is part of a unitary business. Its status as a unitary business allowed the Department to require CUR in this case. Therefore, before I discuss the applicable tax law in this case, a brief overview of the development of combined reporting in the context of unitary businesses is helpful.

As early as the 1920s, tax authorities and courts wrestled with how to deal with multistate corporations whose businesses were so interconnected and “unitary” in nature that it was difficult

to determine where value was being generated for the purpose of tax apportionment. See *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff & Gretton v. State Tax Comm’n*, 266 U.S. 271 (1924); *Hans Rees’ Sons v. State of N. Carolina ex rel. Maxwell*, 283 U.S. 123 (1931). “Because of the complications and uncertainties in allocating the income of multistate businesses to the several States,” the “unitary business principle” was developed, which permitted “[s]tates to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State.” *Allied-Signal, Inc. v. Dir., Div. of Tax’n*, 504 U.S. 768, 778 (1992). In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983) (*Container Corp.*), the U.S. Supreme Court described the “unitary business/formula apportionment method.”

The unitary business/formula apportionment . . . rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the “unitary business” of which the taxed enterprise’s activities in the taxing jurisdiction form one part, and then apportioning the total income of that “unitary business” between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation’s activities within and without the jurisdiction. This Court long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints.

Container Corp., 463 U.S. at 165.

“The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting.” *Allied-Signal, Inc.*, 504 U.S. at 783 (internal quotation marks omitted). Importantly, the unitary business principle only applies to unitary businesses, the hallmarks of which are generally functional integration, centralized management, and economies of scale. *MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep’t of Rev.*, 553 U.S. 16, 30 (2008).

With the development of the unitary business principle, states began to utilize a version of formulary apportionment known as combined reporting, or, as it has been referred to in this case, combined unitary reporting (CUR). The Supreme Court of Illinois aptly summarized the reasoning behind “combined reporting”:

When a unitary business is carried on by an associated group of corporate entities, commonly referred to as a “unitary business group,” resort to formula apportionment is also in order; a group of assets is used by the same overall entity for the generation of income through operation of a single, unitary business. If corporate forms were respected, State income taxation would be as artificially limited and open to manipulation as is the method of separate accounting. To

prevent the triumph of corporate formality over economic substance, “combined reporting” is a necessary tool. . . . Combined reporting works to expand application of the unitary-business concept so that an associated group of corporations can be treated as though it constituted a single taxpayer carrying on a unitary business. The total income of a unitary business as carried on by the associated group is determined by combining the income of each corporation involved in that business, and an apportioning ratio is then applied to that total for determination of the taxable income of the corporate member operating in the taxing State.

Citizens Utilities Co. of Illinois v. Dep’t of Revenue, 111 Ill. 2d 32, 40, 488 N.E.2d 984, 987 (1986).

Additionally, to address the complexities surrounding apportionment, a subset of states adopted the Uniform Division of Income for Tax Purposes Act (UDIPTA).⁵⁷ UDIPTA Section 18 allows for alternative methods of allocation and apportionment. Although not specifically adopted by South Carolina, UDIPTA Section 18 is practically identical to South Carolina’s “alternative apportionment statute,” subsection 12-6-2320(A)(4). Section 18 states:

If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer’s business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer’s business activity in this state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.

UDIPTA § 18 (Westlaw Edge through 2021 Annual Meeting of the National Conference of Commissioners on Uniform State Laws).

Some states that adopted UDIPTA determined Section 18 authorized combined reporting. *See Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 935 S.W.2d 252 (1996); *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989). Other Courts have determined it does not.⁵⁸ Regardless,

⁵⁷ The National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDIPTA) in 1957 to promote conformity among states and their income tax reporting structures. James S. Helms & Geoffrey J. Christian, *The Evolution of UDIPTA Section 18’s Applicability and its Distortion Standard*, 38 J. Corp. Tax’n 3, 3, 2011 WL 2050897, 1.

⁵⁸ *See, e.g., Cook v. Dep’t of Revenue*, 23 Or. Tax 107, 114 (2018) (“The court is of the opinion that, notwithstanding some imprecise language in discussions of courts over the years, combined reporting is a concept and process separate and distinct from that of apportionment. Apportionment is the process by which a ‘base’ of business income is divided among two or more states. . . . However, apportionment of a ‘base’ is separate from determination of the ‘base.’”); *Columbia Sportswear USA Corp. v. Indiana Dep’t of State Revenue*, 45 N.E.3d 888, 895 (Ind. T.C. 2015) (“Accordingly, the plain language of Indiana Code § 6–3–2–2(1), like that of Section 18 of UDITPA, ‘deals only with

the threshold necessary to show that relief should be granted under Section 18 has been debated.

The current official comment to Section 18 reads:

Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in Section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

Id. While the comment vests the taxing authority with "broad authority," in practice tax authorities and courts have struggled to define when standard apportionment does not "fairly represent the extent of the taxpayer's business activity in this state." Professor William Pierce, a drafter of UDIPTA, commented that Section 18

necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.

Twentieth Century-Fox Film Corp. v. Dep't of Revenue, 299 Or. 220, 227, 700 P.2d 1035, 1039 (1985) (quoting William Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (1957)).

Corporate Taxation in South Carolina

South Carolina imposes an income tax of 5% on the "South Carolina taxable income" of every corporation doing business or having income in this state. S.C. Code Ann. § 12-6-530 (2014). "South Carolina taxable income" is computed under the Internal Revenue Code (federal

the question of the fairness of the [allocation or apportionment] of income, not with the determination of the tax base itself.' "); *Joslin Dry Goods Co. v. Dolan*, 200 Colo. 291, 295, 615 P.2d 16, 18 (1980) ("Section 39-22-303(5) provides that the department may distribute or allocate income and deductions, or may require returns on a consolidated basis. We conclude that it is that statutory provision for distribution and allocation of income and deductions which authorizes the department to require combined reports since a combined report does allocate or apportion income.").

taxable income) “with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter.”⁵⁹ S.C. Code Ann. § 12-6-580 (2014).

If, like CarMax East, a taxpayer conducts business partly within and partly without South Carolina, then “the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State.” S.C. Code Ann. § 12-6-2210(B) (2014). Additionally, if a taxpayer’s principal business in South Carolina is “selling, distributing, or dealing in tangible personal property,” then it “shall make returns and pay annually an income tax that includes its income apportioned to this State.” S.C. Code Ann. § 12-6-2252(A) (2014). CarMax East is a retailer principally engaged in selling tangible personal property in this state, therefore, subsection 12-6-2252(A) applies.

A taxpayer’s “income apportioned to this State is determined by multiplying the net income remaining after allocation . . . by the sales factor defined in Section 12-6-2280.” § 12-6-2252(A). Pursuant to subsection 12-6-2280(A), “[t]he sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year.” S.C. Code Ann. § 12-6-2280(A) (2014). This statutorily defined method of multiplying a taxpayer’s South Carolina net income by the sales factor is known as “standard apportionment.”

When standard allocation and apportionment does not “fairly represent the extent of the taxpayer’s business activity in the state, the taxpayer may petition for, **or the department may require**, in respect to all or any part of the taxpayer’s business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer’s business activity in the State; or
- (4) **the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.**

⁵⁹ The starting point for computing any corporate tax in South Carolina—under separate reporting or CUR—is federal taxable income. I will use “federal taxable income” to refer to the starting point in a tax calculation. Sometimes, the starting point is referred to the tax “base.” However, since subsection 12-6-2210(B) of the South Carolina Code (2014) refers to imposing our income tax upon a “base which reasonably represents the proportion of the trade or business carried on within this state,” then “base” means the amount of tax against which the 5% corporate tax is applied after modifications and allocation and apportionment. Accordingly, I do not refer to the starting point as the “base.”

S.C. Code Ann. § 12-6-2320(A) (2014) (emphasis added).

Here, the Department determined that standard apportionment did not fairly reflect Petitioner's business activity in South Carolina. *See id.* Therefore, pursuant to its authority under subsection 12-6-2320(A), the Department required Petitioner to employ another method—CUR. Petitioner contests the Department's interpretation and application of subsection 12-6-2320(A).

Subsection 12-6-2320(A)(4) Authorizes the Application of CUR

Petitioner argues the plain language of subsection 12-6-2320(A)(4) does not authorize the Department to require CUR because subsection 12-6-2320(A)(4) only authorizes an alternative **allocation or apportionment** method, not an alternative **reporting** method, like CUR. I conclude subsection 12-6-2320(A)(4) authorizes the Department to impose CUR.

Reporting Methods

Two reporting methods are at issue in this case: separate reporting and combined unitary reporting (CUR). South Carolina is a separate reporting state. Thus, unless otherwise provided, each corporation with a nexus to South Carolina files a separate tax return even if they are part of a "unitary business." *See* S.C. Code Ann. § 12-6-4910(2) (2014) ("Income tax returns must be filed by the following: . . . (2) a corporation subject to tax under this chapter."); S.C. Code Ann. § 12-6-530 (2014) (Imposing an income tax on every corporation "transacting, conducting, or doing business within this State of having income within this State"). Because each corporation in a unitary business files a separate tax return, the federal taxable income of the individual corporation is the starting point for calculating South Carolina income tax. § 12-6-580 ("South Carolina taxable income" is "computed . . . under the Internal Revenue Code with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter.").⁶⁰

In contrast, when CUR is applied, the federal taxable income of the entire unitary group is the starting point for calculating South Carolina income tax. The federal taxable income for the

⁶⁰ Section 12-6-5020 of the South Carolina Code (2014) provides an exception to separate entity reporting; it allows certain related corporations to file a single tax return called a consolidated income tax return. However, a consolidated return is not the equivalent of CUR. A consolidated return taxes the income of the consolidated entities, whereas CUR merely uses the group's net income to better calculate the tax upon a single taxpayer within the group, not the consolidated group as a whole. Additionally, only corporations that are subject to tax in South Carolina are allowed to be included in the consolidated return, and each corporation in the consolidated return must separately determine its South Carolina taxable income or loss. § 12-6-5020(B)-(D).

unitary group is then modified and subject to allocation and apportionment. Moreover, because the unitary group's federal taxable income is the starting point, the apportionment factor must be altered to adjust for the additional group income. This adjustment does not necessarily change the basic formula of the apportionment factor; rather, it changes what is included in the apportionment factor. For example, in South Carolina, when CUR is imposed, the sales factor remains a ratio of South Carolina sales divided by sales everywhere else. However, instead of the single taxpayer dividing their South Carolina sales by their sales everywhere else, the taxpayer divides the unitary group's South Carolina sales by the unitary group's sales everywhere.

Thus, the reporting method affects the calculation of South Carolina income in a couple ways. First, it affects whether the tax calculation starts with a single entity's federal taxable income or the unitary group's federal taxable income. Second, the reporting method also affects how the apportionment factor is calculated. The question presented in this case is whether subsection 12-6-2320(A)(4) of the South Carolina Code authorizes the Department to deviate from separate reporting to require CUR under certain circumstances.

Interpretation of Subsection 12-6-2320(A)(4)

Although the reporting method can affect the apportionment factor, because it also affects the starting point of federal taxable income, Petitioner contends a change to the reporting method is not authorized under the plain language of subsection 12-6-2320(A)(4). Petitioner claims subsection 12-6-2320(A)(4) only authorizes the Department to adjust the "method of allocation and apportionment," not the amount of federal taxable income from which the tax calculation starts.

In support of its argument, Petitioner cites to *Columbia Sportswear USA Corp. v. Indiana Department of State Revenue*, 45 N.E.3d 888 (Ind. Tax Ct. 2015) (*Columbia Sportswear*). In this case, the Indiana Tax Court had to determine whether Indiana's alternative apportionment statute (which was modeled after Section 18 of UDITPA, like South Carolina's) allowed the state's taxing agency to change the base income (federal taxable income) prior to apportioning such income. *See id.* at 892-94. The Indiana Tax Court held that allowing the taxing agency to adjust the base income, in addition to adjusting allocation and apportionment, would be like trying to pound a square peg into a round hole, and it was contrary to the plain legislative intent of the alternative apportionment statute. *See id.* at 896. Petitioner contends Indiana's alternative apportionment statute and tax system are the same as South Carolina's; therefore, this Court should, like the

Indiana Tax Court, find South Carolina’s alternative apportionment statute does not authorize the Department to alter federal taxable income.

Obviously, this Court is not bound by the decision of another state. Moreover, other states have interpreted the alternative apportionment statute differently than Indiana, including South Carolina. *See, e.g., Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 935 S.W.2d 252 (1996); *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989). In *Media General Communications, Inc. v. South Carolina Department of Revenue (Media General)*, the South Carolina Supreme Court held subsection 12-6-2320(A)(4) authorized the Department to apply CUR. 388 S.C. 138, 146, 694 S.E.2d 525, 529 (2010). Thus, *Media General* stands for the principle that subsection 12-6-2320(A)(4) is broad enough to encompass an adjustment to the reporting method.⁶¹

Petitioner disputes this interpretation of *Media General*, arguing our supreme court did not hold subsection 12-6-2320(A)(4) authorizes CUR. Instead, Petitioner claims that imprecise language in the ALC’s underlying decision in *Media General* led the supreme court to approve a **different method of apportionment**, not CUR. Moreover, Petitioner asserts the method approved by the supreme court was not the method advocated or intended by the parties or the ALC.

Regarding “imprecise language,” the *Media General* opinion includes a quotation about “combined entity apportionment”⁶² from the ALC’s underlying order that is slightly misleading:

To determine the tax of a related entity or related entities of a multistate corporation in South Carolina by using the combined entity apportionment method, the individual entity or all related entities (if more than one taxpayer is transacting business in this state), must determine a ratio to apply against its/their taxable income to arrive at its/their net taxable income in South Carolina. The ratio is determined by dividing the gross receipts of all the related entities of the multistate corporation in South Carolina or all the related entities['] property, payroll, and sales from within South Carolina, by all the related entities['] gross receipts from everywhere or the related entities['] property, payroll, and sales from everywhere.

⁶¹ Petitioner argues this Court should engage in statutory construction of subsection 12-6-2320(A)(4) to resolve this case. However, courts usually engage in statutory construction to interpret a statute when it has not previously been interpreted and/or its meaning becomes unclear in a particular application. *See Hodges v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000) (“The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature.”); *Eagle Container Co., LLC v. Cnty. of Newberry*, 379 S.C. 564, 570, 666 S.E.2d 892, 895 (2008) (“We proceed from the familiar premise that in the area of statutory construction, our role is limited to determining legislative intent and effectuating that intent.”). In this case, the South Carolina Supreme Court has already interpreted the meaning of subsection 12-6-2320(A)(4) within the context of whether combined unitary reporting is authorized under that subsection. Therefore, this Court does not need to engage in statutory construction.

⁶² In *Media General*, both the underlying ALC order and the South Carolina Supreme Court referred to combined unitary reporting (or simply combined reporting) as “combined entity apportionment,” which appears to be a linguistic combination of “combined reporting,” “separate entity reporting,” and “apportionment.”

The taxpayer (individual entity) then applies this ratio to the entity's taxable income in South Carolina to determine its net taxable income. The corporate tax rate (5%) is then applied to ascertain the tax owed this State.

Media General, 388 S.C. at 146–47, 694 S.E.2d at 529 (emphasis added). Clearly, the bolded language is not as precise as it could be. When viewed in isolation, specification of “the taxpayer (individual entity)” and “the entity’s taxable income” in the bolded section could arguably lead Petitioner to conclude that a combined sales factor (group’s South Carolina sales/group’s sales everywhere) is applied against the single taxpayer’s federal taxable income instead of against the group’s federal taxable income. *Id.* This conflation would result in an absurd interpretation because it would mix separate reporting with combined reporting. However, when this quote is reviewed in the context of the ALC’s original order from which it came, it becomes unquestionably clear that the combined sales factor is applied against the group’s federal taxable income, consistent with CUR:

- “The term ‘combined apportionment methodology’ means the following when used herein: an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income attributable to activities in South Carolina by taking a portion of the **combined net income of the group** through the utilization of **combined apportionment factors**.”
- “The purpose of the combined apportionment methodology is to determine the income or other tax base of the in-state taxpayer by viewing the taxpayer as part of the unitary business, and applying the apportionment factors of the entire unitary business **to the taxable net income of the unitary business** and 2) to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise.”
- “A state could select the combined report method [combined apportionment method] whereby the **entire net incomes of several commonly owned unitary corporations . . . are included in the taxpayer’s apportionable unitary net income base**. . . . Any of these methods are permitted.”

See Media Gen. Commc’ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep’t of Revenue, Docket No. 07-ALJ-17-0089-CC, and *Media General, Inc. v. S.C. Dep’t of Revenue*, Docket No. 07-ALJ-17-0090-CC, at 12-13, 28 (emphasis added). Indeed, a complete reading of the ALC’s opinion leaves no doubt that when the ALC discussed “combined entity apportionment,” it was referring to CUR and the two linguistic formulations of this “method” are interchangeable.

Nevertheless, Petitioner argues the supreme court did not approve the method discussed in the ALC’s underlying order; rather, it approved a new method that only altered apportionment and

did not alter federal taxable income (thus mixing combined reporting with separate reporting). However, the supreme court affirmed the ALC's order **without modification**. Therefore, the supreme court intended to uphold the method approved by the ALC, which was CUR, even though it was called "combined entity apportionment" in the opinion.

Furthermore, the supreme court's own description of "combined entity apportionment" confirms, consistent with CUR, that the group's federal taxable income was utilized rather than the federal taxable income of the single taxpayer:

[Separate entity apportionment] is in contrast to the combined entity apportionment method, which the parties have stipulated is defined for this matter as an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income attributable to activities in South Carolina by taking a **portion of the combined net income of the group** through the utilization of combined apportionment factors. **The combined income of the unitary group is not computed for the purpose of taxing such income**, but rather as a basis for determining **the portion of income from the entire unitary business attributable to sources within South Carolina that is derived by members of the group subject to South Carolina's taxing jurisdiction**. One of the purposes of this method is to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise.

Media General, 388 S.C. at 142, 694 S.E.2d at 527 (emphasis added). The bolded portions of this quote from *Media General* show the supreme court interpreted combined entity apportionment to utilize the "combined income of the unitary group," aka the group's federal taxable income, as a starting point against which the combined sales factor was applied. *Id.* This describes CUR.

To the extent Petitioner asks this Court to deviate from the supreme court's interpretation, our supreme court's decision in *Media General* is a fair and reasonable interpretation of our statutory scheme, even if another state, like Indiana, interprets a similar scheme differently. *Compare Media General*, 388 S.C. 138, 146, 694 S.E.2d 525, 529, with *Columbia Sportswear*, 45 N.E.3d 888; *see also McLeod v. Starnes*, 396 S.C. 647, 655, 723 S.E.2d 198, 203 (2012) ("Stare decisis applies with full force with respect to questions of statutory interpretation because the legislature is free to correct us if we misinterpret its words."). In fact, it makes sense that CUR would fall under the umbrella of apportionment in subsection 12-6-2320(A) because it ultimately seeks to more fairly apportion the income of unitary taxpayers among taxing jurisdictions.

Additionally, subsection 12-6-2320(A) provides for the use of alternative methods of allocation and apportionment, "[i]f the allocation and apportionment provisions **of this chapter** do not fairly represent the extent of the taxpayer's business activity in this State." (emphasis

added). Thus, this subsection must be read within the context of Chapter 6 of Title 12 (governing allocation and apportionment). *See TNS Mills, Inc. v. S.C. Dept. of Revenue*, 331 S.C. 611, 503 S.E.2d 471 (1998) (“In construing statutory language, the statute must be read as a whole, and sections which are part of the same general statutory law must be construed together and each one given effect.”). One provision of importance in Chapter 6 is subsection 12-6-2210(B), which instructs that “[i]f a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon **a base which reasonably represents the proportion of the trade or business carried on within this State.**” (emphasis added). According to the Department’s evaluation of Petitioner’s tax returns during the audit period, the South Carolina income tax was imposed upon a base (CarMax East’s federal taxable income) that did not “reasonably represent the proportion of the trade or business carried on within this State,” contrary to subsection 12-6-2210(B). *See Duke Energy Corp. v. S.C. Dep’t of Revenue*, 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016) (holding the primary thrust of South Carolina’s apportionment statutes is “to apportion to South Carolina a fraction of the taxpayer’s total income reasonably attributable to its business activity in this State”).

Therefore, while an isolated reading of the section quoted from the ALC’s order in *Media General* may lead one to infer that “combined entity apportionment” only impacts the calculation of the apportionment (sales) factor under section 12-6-2280, that inference would be incorrect—combined entity apportionment is the same as CUR, which affects the federal taxable income starting point and the apportionment factor. Moreover, our supreme court’s decision is reasonable under South Carolina’s statutory scheme. *See* § 12-6-2320(A); § 12-6-2210(B).

The Department Met Its Burden

In cases where the Department asserts an alternative apportionment method under subsection 12-6-2320(A)(4), our supreme court has held the Department bears the burden of proof. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep’t of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014); *Rent-A-Ctr. W. Inc. v. S.C. Dep’t of Revenue*, 418 S.C. 320, 792 S.E.2d 260 (Ct. App. 2016). To meet its burden, the Department must prove: (1) that the statutory formula does not fairly represent CarMax East’s business activity in South Carolina and (2) that the proposed alternative formula is reasonable and equitable. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200.

CarMax East's Business Activity is Not Fairly Represented

Subsection 12-6-2320(A) requires the Department to show the extent of CarMax East's "business activity" in South Carolina is not fairly represented by standard allocation and apportionment.

Business Activity

"Business activity" is not defined for the purposes of subsection 12-6-2320(A). However, from a factual perspective, CarMax East's business activity in South Carolina is clear. CarMax East's business activity during the audit period was selling and purchasing cars and selling EPPs. Additionally, CBS's South Carolina business activity in South Carolina was reported on CarMax East's and CarMax's West's South Carolina tax returns. Thus, CarMax East also reported CBS's South Carolina business activity on its tax return, to include licensing income from IP utilized in South Carolina and finance income from loans that originated in South Carolina.⁶³ And, while in some cases income may not reflect business activity, here, where all of CarMax East's business activity results in revenue, I find that income is a proxy for CarMax East's business activity in this state.⁶⁴

Type of Evidence Sufficient to Show Unfair Representation

Next, in *Carmax* and *Rent-A-Center*, our courts have discussed the type of evidence that is sufficient, or insufficient, to show whether business activity is fairly represented. *See Carmax*, 411 S.C. at 90–91, 767 S.E.2d at 201; *Rent-A-Center*, 418 S.C. at 333, 792 S.E.2d at 267. Additionally, in Revenue Ruling #15-5, the Department has provided guidance about how it determines whether business activity is fairly represented under subsection 12-6-2320(A)(4).

In *Carmax*, the South Carolina Supreme Court held the evidence offered by the Department was insufficient to meet its burden to show the statutory formula did not fairly represent CarMax West's business activity in South Carolina. 411 S.C. 79, 90–91, 767 S.E.2d 195, 201 (2014). The court cited the following evidence as insufficient: (1) testimony from the Department's auditor that the "business structure of CarMax West and CBS is often 'linked with tax minimization

⁶³ CarMax West also paid tax in South Carolina based upon the pass-through income it received from CBS related to licensing and finance income sourced to South Carolina.

⁶⁴ *Cf. Twentieth Century-Fox Film Corp.*, 299 Or. at 233–34, 700 P.2d at 1042–43 (1985) ("It is also important to note that it must be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state.").

strategies,” (2) “the fact that CarMax West’s apportionment ratio yielded a significantly lower tax than that of CarMax East” in support of the Department’s “determination that CarMax West’s income was diluted,” and (3) “bald assertions by [the Department’s] witnesses that it satisfied this threshold question.” *Id.* at 90-91, 767 S.E.2d at 201.

The South Carolina Court of Appeals likewise found the Department failed to meet its burden in *Rent-A-Center West Inc. v. South Carolina Department of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016). The court of appeals rejected the following Department testimony because it was insufficient to show the statutory formula did not fairly represent Rent-A-Center’s business activity in South Carolina: (1) Rent-A-Center was comprised of multiple entities and the Department auditor believed a management services fee was too high and (2) the Department’s expert indicated that excluding the retail operations from the calculations was essential to “come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina” and “using the standard apportionment method would be like having apples in the numerator, while having apples and oranges in the denominator.” *Id.* The court of appeals specifically noted that the Department’s auditor “did not point to any specific evidence the standard apportionment method did not fairly represent RAC West’s business activities.” *Id.*

Based upon these two cases, it is clear the Department must provide specific evidence supporting its assertion that standard allocation and apportionment does not fairly reflect CarMax East’s business activity in South Carolina. *See Carmax Auto Superstores W. Coast, Inc.*, 411 S.C. at 90-91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. In other words, the Department cannot rely on business characteristics or business structures that “may” indicate a tax minimization scheme, bald assertions of unfairness or distortion, or a contention that standard allocation and apportionment results in less tax to this state. *See id.*

Next, in Revenue Ruling #15-5, the Department outlined “[s]ome of the facts” it may consider when determining if the standard allocation and apportionment fairly represents the extent of a taxpayer’s business in South Carolina. Revenue Ruling #15-5 at 6. Those facts include:

- (1) amounts paid to related parties for good and services or goods and services provided without payment;
- (2) profit margins associated with business activities;
- (3) capital investments associated with business activities;
- (4) whether goods and services are provided to both related and unrelated parties on similar terms;

(5) whether taxpayers in similar industries provide similar good and services to unrelated parties under similar terms; and

(6) whether the taxpayer would be willing to enter into a similar arrangement with an unrelated third party considering, among other issues, the relinquishment of control over the business activity.

Revenue Ruling #15-5 at 6-7.

Revenue Ruling #15-5 also states that a Section 482 transfer pricing study supporting prices between related entities “is not determinative of whether South Carolina’s statutory apportionment formula fairly represents the taxpayer’s business activities in South Carolina.” *Id.* at 7. It further states that the Department has required or approved CUR “in situations involving the use of purchasing companies, management fee companies, and ‘east/west’ companies within a unitary group.” *Id.* at 7 (footnotes omitted). Revenue Ruling #15-5 defines a “management fee company” as “a member of the unitary business group that provides general management services to related operating companies for a fee.” *Id.* at 7 n.14. “East/west companies” are defined as:

generally members of a unitary business divided into two corporations. The west company is located in a state where combined unitary reporting including both the west and east company is required. The east company is located in a state where separate entity reporting is required. The east company pays the west company for the use of intangibles, management fees, or other services generating an expense for the east company. The west company’s income is not increased by these payments since the west company is already filing a combined unitary report that includes the east company.

Id. at 7 n.15.

Not Fairly Represented by Standard Allocation and Apportionment

I conclude the Department showed by a preponderance of the evidence that the extent of CarMax East’s business activity in South Carolina is not fairly represented by standard allocation and apportionment. *See* § 12-6-2320(A)(4) (providing the Department may require another method when standard allocation and apportionment do not “fairly represent the extent of the taxpayer’s business activity in the state”). Specifically, the evidence established that CarMax East shifted most of its taxable income to CarMax West through the Management Fee and the CBS partnership—a partnership whose non-arm’s length distributions shifted income within an east-west structure. The partnership distributions were not arm’s length because they did not reflect the valuable contributions of the parties to the partnership.

As a result of the income shifting, CarMax East's federal taxable income and its South Carolina taxable income was significantly and unjustifiably reduced. This reduction does not fairly reflect the extent of CarMax East's business activity in South Carolina, for which income is a proxy. Moreover, separate reporting and standard allocation and apportionment do not correct for this unjustified reduction; rather, they create a safe harbor for it.

The Management Fee and East-West Structure Distorted CarMax East's Business Activity

In requiring CUR, the Department relied, in part, on the presence of a management fee and an east-west structure. The mere existence of a management fee and an east-west structure do not necessarily merit the imposition of CUR. A management fee, when appropriately priced to mimic uncontrolled transactions, should be respected. Similarly, an east-west structure is not illegal. Indeed, it is acceptable to take advantage of different states' tax regimes, as long as the movement of income from east to west has a legitimate business purpose with substance. In other words, the company's structure, alone, should not merit the imposition of CUR. In this case, however, the evidence established the Management Fee and the partnership distributions work together to shift a substantial amount of income from CarMax East to CarMax West, in an east-west structure, for no discernable business reason other than tax minimization.

At trial, the Department did not rely on the mere existence of a management fee. The Department showed by a preponderance of the evidence that the Management Fee was not reliable under the 482 Regulations. Furthermore, the Department's evidence established that the Management Fee was too high.⁶⁵ But, because neither party produced a reliable arm's length range for comparison, I cannot find the Management Fee, on its own, distorted CarMax East's business activity such that it was not fairly represented by standard allocation and apportionment.

Nevertheless, the Management Fee was integral to CarMax's overall scheme to shift money from CarMax East to CarMax West because the initial shift of money away from CarMax East, and to CBS, was accomplished through the Management Fee. That initial shift to CBS allowed the partnership to then siphon money to CarMax West through the partnership distributions. Thus, even if the Management Fee charged during the audit years was an arm's length fee, the partnership

⁶⁵ In particular, the Management Fee did not account for any origination fees that CAF would have paid to CarMax East and CarMax West. Thus, the Management Fee was too high to the extent it did not credit CarMax East and CarMax West with origination fees spread over a per car basis (since not every customer needs financing).

distributions shifted a substantial amount of the income CBS earned from the Management Fees disproportionately back to CarMax West, in an east-west structure. Through these intercompany transactions, CarMax East reduced its federal taxable income by \$1.6 billion for the audit period while CarMax West increased its federal taxable income by \$1.4 billion.

More specifically, CarMax East generated about 75% of the Group's revenues and, likewise, contributed about 75% of the income CBS earned from its Management Fees. However, CarMax East was only attributed with about 20% of the Group's taxable income because the rest of its revenue that would have become taxable income was shifted to CarMax West through CarMax West's 93.5% interest in the partnership.⁶⁶

Conversely, because CarMax West received 93.5% of CBS's income, although it only produced 25% of the Group's revenues and 25% of CBS's Management Fees, it was attributed with about 80% of CarMax's taxable income. Stated differently, although CarMax West produced 33% of the income CarMax East produced, CarMax West's income produced 541% more federal taxable income than CarMax East because of how the management fee and partnership siphon income from CarMax East to CarMax West.

As these percentages show, the partnership distributions distorted CarMax East's taxable income.⁶⁷ The distortive effect of the partnership on South Carolina tax is also significant. Dr. DeRamus explained that over the course of the three audit years, CarMax East's South Carolina stores had a total operating profit of approximately \$90,000,000; however, their taxable income apportioned to South Carolina was only approximately \$21,000,000. The difference in those values reflects the movement of income from CarMax East to CBS through the Management Fee, and

⁶⁶ Stated differently, CarMax East had a net taxable income return of \$10.54 for every \$100 of income it produced while CarMax West had a net taxable income return of \$57.00 for every \$100 of income it produced. Petitioner complains that these "distortion ratios" do not help the Department meet its burden and are not published, thus failing to provide taxpayers with notice that they will be used. The Department is not required to publish notice of every mathematical calculation it might possibly make to show that a certain method does not fairly reflect business activity within this state. Companies and their structures are unique—where one mathematical ratio illuminates an aspect of one company, it may not do so for another. Under the facts of this case, I find the "distortion ratios" used by the Department demonstrate that income is not flowing between the companies in the manner one would expect, which signals distortion if not otherwise justified.

⁶⁷ Petitioner complains the Department used the sales percentages to improperly apply something called the "matching principle." Under the matching principle, the Department contended the money flowing back to CarMax East and CarMax West through the partnership should be in proportion to how much each company contributed to CBS's earnings through the Management Fees they paid. While the Department may have relied, in part, on this principle, the Court does not. Nevertheless, the discrepancy between how much income CarMax East earns and how much taxable income it produces is evidence of distortion in this case.

then the flow through of the vast majority of CBS's income back to CarMax West under the partnership's terms.

The Structure of the Partnership Was Not Justified

I conclude the distortive effect of the partnership distributions was not legally or factually justified to show that the purpose of the distributions was other than tax minimization using an east-west structure. Specifically, the evidence established that CarMax West's assigned 93.5% interest in the CBS partnership, which caused so much of CarMax East's income to be shifted to CarMax West, was unsupported by its contributions to the partnership.

When CBS was formed, CarMax East agreed to give up valuable business process intangibles to CarMax West for zero compensation. Because the business process intangibles were a valuable asset that an uncontrolled taxpayer would have paid a sum to acquire, exchanging them for no compensation was not an arm's length transaction. 26 C.F.R. § 1.482-1(b) ("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."). Then, almost simultaneously, CarMax West contributed the business process intangibles to CBS, largely in consideration for which it was awarded a 93.5% ownership percentage in CBS. Subsequently, CarMax East agreed to pay CBS a large portion of the Management Fee for use of these same intangibles it gave away. Again, an uncontrolled party in CarMax's East's position would not engage in this kind of behavior, and the transfer was not arm's length. *Id.*

Because CarMax West did not pay CarMax East for the business process intangibles, CarMax West's distributional share of the partnership should not have been valued based on its contribution of these intangibles. Rather, CarMax East should have received credit for contributing the business process intangibles to the partnership. Therefore, the distributional shares of the partnership do not reflect the partners' valuable contributions. To put it succinctly, the form of the transaction(s) creating CBS did not match the substance. Thus, while there was no clear evidence that tax avoidance was an expressed intent of CarMax when it structured the partnership, there is no other explanation in the record for this structural setup.⁶⁸

⁶⁸ This effect is exacerbated to the extent that the transfer prices under the MMSA are inflated and siphon more income to CBS than is appropriate.

Moreover, Petitioner failed to justify why CarMax West was entitled to credit for contributing the business process intangibles to CBS other than the legal reality that CarMax West technically owned them at the time of their contribution. In other words, Petitioner failed to show how the economic substance of the transaction supported its legal form. Instead, Petitioner repeatedly argued that because the partnership distributions were set in 2004, they are beyond this Court's scope of review, and they are irrelevant to this case. Petitioner further asserts in its proposed order that

[e]ven if the 2004 Valuation Study was egregiously incorrect as DeRamus suggested, CarMax East still owned 6.5% of CBS during the Audit Period, and the issue before the Court would still be whether CarMax East's tax returns during the Audit Period fairly reflect (1) the South Carolina business activity of CarMax East during the Audit Period, plus (2) 6.5% of the South Carolina business activity of CBS during the Audit Period.

Petitioner makes no legal argument why the Court should simply respect partnership distributions without further inquiry. Petitioner merely asks the Court to find them irrelevant.

Based upon the evidence presented to this Court, the operation of the partnership percentages is extremely relevant to this case. Petitioner's reluctance to address this topic only operates to its detriment. If there is evidence that the partnership percentages reflect the valuable contributions of the parties, and substance matches form, Petitioner should have presented it. If there is a sound legal reason to respect the partnership distributions, even if they distort South Carolina business activity, Petitioner should have presented this argument as well.

In sum, based on the evidence before the Court, the shift in income from CarMax East to CarMax West does not fairly represent the extent of CarMax East's business activity in the state during the audit period.

Separate Reporting and Standard Allocation and Apportionment Provided a Safe Harbor

While it may be true that the legislature intended for separate reporting to provide an advantageous tax environment, it cannot be true that the legislature intended to provide a safe harbor for intercompany transactions that distort a company's business activity in this state such that its business activity is not fairly represented for tax purposes. Here, CarMax's intercompany transactions artificially and significantly reduce CarMax East's taxable income. Yet, because separate reporting and standard allocation and apportionment respect intercompany transactions,

they do not correct for this issue. Rather, they shelter intercompany transactions that abuse the state's tax scheme.

In this case, standard allocation and apportionment produces a sales factor that is based upon CarMax East's sales in South Carolina divided by its sales everywhere. Normally, this ratio is a perfectly rational way to apportion income to a taxpayer. However, because of the income shifting, this ratio is applied against a federal taxable income that is artificially reduced because separate reporting respects this artificial reduction without question. As a result, standard apportionment does not produce a result that fairly represents the business activity; it produces an artificially lowered amount of taxable income that does not represent business activity because the ratio is applied against a smaller amount of taxable income than it should be.

More specifically, CarMax East's South Carolina stores had a total operating profit of approximately \$90,000,000; however, their taxable income apportioned to South Carolina was only approximately \$21,000,000. Thus, by shifting income from CarMax East to CarMax West through the Management Fee and the partnership distributions, the starting point (federal taxable income) for calculating South Carolina's income tax is significantly reduced, and for no reasonable purpose relating to business activity. Further, by artificially lowering CarMax East's federal taxable income, South Carolina's apportionment factor is applied against a much smaller starting number that then produces a significantly lower amount of tax that does not fairly represent the amount of business activity that takes place in the state. Moreover, because CarMax West is only taxed in South Carolina on its receipts from IP and financing, the portion of CarMax East's income from its retail sales that is shifted to CarMax West effectively escapes any calculation of taxation in South Carolina. Separate reporting, including standard allocation and apportionment, cannot capture this significant, unsupported re-routing of income from one taxpayer to another in a separate jurisdiction because separate reporting respects the taxpayer's corporate structure and the taxpayer's federal taxable income that results from that structure.

Since I find the extent of CarMax East's business activity in South Carolina is not fairly represented by standard allocation and apportionment under separate reporting, I now turn to whether the Department's imposition of CUR was reasonable and equitable.

Reasonable and Equitable

I conclude the Department met the second part of its burden, which is to show the application of CUR would be reasonable and equitable.

Pursuant to subsection 12-6-2320(A), “the department may require, in respect to all or any part of the taxpayer’s business activity, if **reasonable** . . . (4) the employment of any other method to effectuate an **equitable** allocation and apportionment of the taxpayer’s income.” § 12-6-2320(A)(4) (emphasis added). *See Carmax*, 411 S.C. at 89, 767 S.E.2d at 200 (holding “the proponent of the alternate formula bears the burden of proving by a preponderance of the evidence that . . . its alternative accounting method is reasonable”).

The definitions of “reasonable” and “equitable” are very similar. Generally, “reasonable” means “fair, proper, or moderate under the circumstance,” while “equitable” means “just; consistent with principles of justice and right.” *See Reasonable*, BLACK’S LAW DICTIONARY (11th ed. 2019); *see also Equitable*, BLACK’S LAW DICTIONARY (11th ed. 2019). Similarly, Merriam-Webster defines “equitable” as “dealing fairly and equally with all concerned” and “reasonable” as “moderate, fair.” *See* <http://www.merriam-webster.com/dictionary/equitable> (last visited on July 11, 2024); *see also* <http://www.merriam-webster.com/dictionary/reasonable> (last visited on July 11, 2024).

In addition to these definitions, in Revenue Ruling #15-5, the Department set forth two criteria that it uses to evaluate reasonableness: (1) the division of income must fairly represent the taxpayer’s business activity in this State and, if applied uniformly, would result in taxation of no more or no less than 100% of the taxpayer’s income; and (2) the division of income must reflect the economic reality of the business activity engaged in by the taxpayer in this State.⁶⁹ I find that these criteria are a legally sound method of assessing reasonableness and equity under the facts of this case.

In making this determination, I recognize that it is not reasonable to require CUR simply because a business is a unitary business. *See, e.g., Rent-A-Ctr. E., Inc. v. Indiana Dep’t of State Revenue*, 42 N.E.3d 1043, 1048 (Ind. T.C. 2015) (“Regardless of a possibility of distortion, however, Indiana’s AGIT statutory framework does not require a member of a unitary group to file a combined income tax return solely because there is a unitary relationship.”). It is also not reasonable to impose combined unitary reporting merely because it will result in more tax than separate entity reporting. *See Carmax*, 411 S.C. at 91, 767 S.E.2d at 201 *citing with approval St.*

⁶⁹ These criteria were based upon the Oregon Supreme Court’s three-part test for “reasonableness” in *Twentieth Century-Fox Film Corporation v. Department of Revenue*, 299 Or. 220, 700 P.2d 1035 (1985). Although the Oregon Supreme Court set forth three criteria, the Department correctly observed that the second element of the Oregon Supreme Court’s test only applies to UDIPTA jurisdiction, which South Carolina is not.

Johnsbury Trucking Co. v. State, 118 N.H. 209, 212, 385 A.2d 215, 217 (1978) (“Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.”).

Requiring CUR is Reasonable and Equitable

Applying subsection 12-6-2320(A) and this guidance, I find requiring CUR is reasonable, if properly applied, because it corrects the shift in income that distorts CarMax East’s federal taxable income while retaining a reasonable and equitable allocation and apportionment of CarMax East’s income to this state. Specifically, under CUR, the starting point of calculating South Carolina taxable income is the federal taxable income of the entire unitary group. As a result, the income that was shifted from CarMax East to CarMax West to artificially reduce CarMax East’s federal taxable income is returned and the distortive effect of Management Fee and partnership distributions is eliminated. Then, because CUR starts with the Group’s federal taxable income, CUR also alters the sales factor to reflect the Group’s South Carolina sales divided by the Group’s sales everywhere. In this particular case, the changes to the sales factor resulted in a smaller sales factor ratio. Thus, under CUR, the starting point of federal taxable income was bigger, but the sales factor ratio was smaller to retain proper proportions of what is being measured (apples to apples). Because federal taxable income is in proportion to the combined sales factor, the result of CUR is a taxable base **for the Group** reasonably attributed to South Carolina income from retail sales, licensing, and finance income (business activity).

However, once the Group’s income attributable to South Carolina is calculated, then, pursuant to Revenue Ruling #15-5, the Department is supposed to apply the *Finnegan* method to divide this income between the South Carolina taxpayers—CarMax East and CarMax West. This method is described as follows in Revenue Ruling #15-5:

Under *Finnigan*, all members of the combined unitary group are viewed more like a single taxpayer. The unitary group income is apportioned to the state for the group as a whole. The income of all unitary members is multiplied by a single sales factor (*Finnigan* sales factor). The numerator of the *Finnigan* sales factor includes total sales to South Carolina of all members of the unitary group including those members protected by PL 86-272 and/or do not have nexus with South Carolina. The denominator includes total sales everywhere for all unitary members.

The Department will apply the *Finnigan* method to apportion the unitary income using a two-step process. As previously discussed, South Carolina’s apportionment is a single factor sales/gross receipts formula. Total sales to South Carolina are

divided by total sales everywhere and then multiplied by unitary income subject to apportionment. First, the unitary group income is apportioned to South Carolina for the group as a whole. This apportionment formula uses the South Carolina sales of all members of the combined unitary group in the sales factor numerator, including those members that are not subject to tax in South Carolina. The denominator includes total sales everywhere for all unitary members. **The second step is to divide that state income among the members that are taxpayers subject to tax in South Carolina.** In other words, the second step does not assign any of the South Carolina income to members without South Carolina nexus or those members protected by PL 86-272.

Revenue Ruling #15-5 at 9 (emphasis added). I find that the *Finnegan* method of dividing this income between the South Carolina taxpayers is reasonable and equitable.

Overall, the evidence demonstrated that if CUR is properly applied using the *Finnegan* method, applying CUR would be a reasonable and equitable alternative method under subsection 12-6-2320(A). Because CUR corrects for the artificial reduction of CarMax East's federal taxable income, its result will produce taxable income apportioned to CarMax East that better reflects the economic reality of CarMax East's business activity in this state. *See* Revenue Ruling #15-5; *Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43. Moreover, if applied uniformly, CUR would not result in taxation of more or less than 100% of the taxpayer's income. *See id.* In contrast, under separate reporting and standard apportionment, the economic reality that CarMax East had around \$90,000,000 in South Carolina sales was distorted by the partnership distributions to reflect only \$21,000,000 worth of taxable business activity.

Additionally, when *Finnegan* is properly applied, the result will be equitable because it will justly and fairly apportion that taxable income due to South Carolina between CarMax East and CarMax West. Shifting income back to CarMax East under CUR prevents the sales income (business activity) that was shifted to CarMax West under the partnership distributions and separate reporting from escaping taxation.

However, in this case, the Department did not apply the *Finnegan* method to divide the South Carolina taxable income between the two South Carolina taxpayers: CarMax East and CarMax West. Rather, it assigned all the South Carolina taxable income to CarMax East and then credited CarMax East with the amount of tax CarMax West had already paid during the audit years. Although CarMax East and CarMax West are related companies, they filed separate tax returns during the audit period and this separation should have been acknowledged by the Department in its calculations. As a result, I conclude the matter must be remanded to the Department to apply

the *Finnegan* method and issue amended tax assessments to both CarMax East and CarMax West for the audit period.

Gross Over-Correction and Over-taxation

Petitioner also argues that CUR is unreasonable and a gross over-correction. Petitioner asserts CUR results in CarMax East being severely over-taxed contrary to the guidance in Revenue Ruling #15-5, which directs that CUR should result in taxation of no more or no less than 100% of the taxpayer's income. *See* Revenue Ruling #15-5; *see also Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43. Specifically, Petitioner contends that during the audit period, approximately 3.49% of CarMax East's total business activity took place in South Carolina, yet CUR would impose a tax on approximately 10.86% of CarMax East's total income subject to apportionment.⁷⁰ Petitioner further argues it is patently unreasonable to impose tax on 10.86% of CarMax East's total income subject to apportionment when only 3.49% of CarMax East's total business activity occurred in South Carolina. Moreover, if all states uniformly applied CUR against CarMax East in this manner, the end result would cause CarMax East to pay tax on more than 300% of its income subject to apportionment, not “no more or no less than 100% of the taxpayer's income” as Revenue Ruling #15-5 instructs.

Petitioner's argument relies on its assumption that the Management Fee and partnership distributions do not result in distortion and, therefore, CarMax East's reported federal taxable income is correct and does not need to be adjusted. When the taxable base, as calculated under CUR (the amount subject to the 5% tax), is taken as a percentage of CarMax East's federal taxable income as calculated under separate reporting, then of course it will appear like the Department is taxing an excessive amount of CarMax East's income—you are comparing apples to oranges. Mixing federal taxable income under separate reporting with the taxable base calculated under CUR is going to produce a result that looks like CarMax East is being over-taxed, but the Department did not apply a mixed method like this. Therefore, Petitioner's argument is misplaced.

Targeting CarMax East Instead of CarMax West

Next, Petitioner asserts the Department is making the same arguments it made in *Carmax* in 2014, except the Department is now targeting CarMax East instead of CarMax West. *Carmax*,

⁷⁰ Petitioner asserts CUR resulted in approximately 12.09% of CarMax East's total income being subject to apportionment but after accounting for the credit for taxes paid by CarMax West, that amount was effectively reduced to 10.86%.

411 S.C. 79, 767 S.E.2d 195 (2014). Petitioner essentially complains that this is the same case against a different, related party, but makes no legal arguments why these facts matter; Petitioner simply argues that allowing the Department to make similar arguments in this case is “neither reasonable nor equitable.”

This case is distinguishable from the prior *Carmax* litigation because, in that case, the Department did not seek to impose CUR like it does here. Rather, it sought to impose a different variation of apportionment under subsection 12-6-2320(A)(4) to prevent CarMax West from diluting its sales factor. *Carmax*, 411 S.C. at 84, 767 S.E.2d at 197. Moreover, CarMax West is a different party that was not treated by the Department as a unitary business in that case, and the Department presented different factual evidence to support its alternative apportionment method. *Id.* at 90, 767 S.E.2d at 201 (finding the Department’s evidence consisted of testimony that CarMax West’s and CBS’s business structure is often “linked with tax minimization strategies” and “CarMax West’s apportionment ratio yielded a significantly lower tax than that of CarMax East”). Therefore, without any legal theories to support its generic assertion that allowing the Department to present a **similar yet distinct** case against CarMax East is “neither reasonable nor equitable,” I find this argument without merit.

Wrong Solution

Finally, Petitioner argues that good tax policy would dictate that CUR cannot be used to correct a problem such as the price of a transaction. Petitioner asserts the Department has Section 482 powers exactly for this purpose—to correct transfer pricing issues without changing the reporting method and applying CUR. The crux of Petitioner’s argument is that if there is a problem with the Management Fee, it should be treated like an improper deduction, and subsection 12-6-2320(A)(4) is the wrong tool to fix that sort of problem. Rather, Petitioner asserts the Department should utilize its 482 powers to correct the transfer price, which would correct the problem while respecting the legislature’s choice to have South Carolina be a separate reporting state.⁷¹

⁷¹ Since Petitioner does not think this Court should address the partnership distributions at all, it is unclear whether Petitioner would also have the Department utilize its Section 482 power to fix the distorting effect of the partnership distributions. I note that partnership interests can be reallocated under the 482 Regulations. *See* 26 C.F.R. § 1.704-1(b)(1)(iii) (providing that a partnership “allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482”); 26 C.F.R. § 1.704-1 (Example 28); 26 C.F.R. § 1.482-1(a)(2) (“The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations).”).

In theory, the issues in this case can be fixed using the Department’s Section 482 powers while preserving separate reporting.⁷² Indeed, because South Carolina is a separate reporting state, this method of reporting should not be lightly disregarded, nor an alternative method of reporting/apportionment be lightly imposed. *See Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep’t of Revenue*, 411 S.C. 79, 89–90, 767 S.E.2d 195, 200 (2014); *citing with approval Donald M. Drake Co. v. Dep’t of Revenue*, 263 Or. 26, 500 P.2d 1041, 1044 (1972) (holding “the use of any method other than apportionment should be exceptional” and the party seeking to use an alternative method bears the burden of proof).

Unfortunately, neither the Department nor CarMax East provided the Court with reasonable, arm’s length calculations of the Management Fee or the partnership distributions. Accordingly, this Court has no sound evidence upon which to correct these issues using the Department’s Section 482 powers. Moreover, even if the Department could have used its Section 482 powers to correct the distortion in this case, the fact remains that under a plain reading of subsection 12-6-2320(A)(4), CarMax East’s business activity was not fairly represented under separate reporting and standard allocation and apportionment during the audit period. Thus, the Department acted within its authority to require an alternate method—CUR—under subsection 12-6-2320(A).⁷³ *See Media General*, 388 S.C. at 146, 694 S.E.2d at 529.

Finally, I note that although correcting the intercompany transactions may have allowed separate reporting to remain intact, as this case clearly demonstrates, correcting transfer prices in distortive intercompany transactions is a complicated and fraught venture that takes enormous time and resources to ostensibly arrive at the same result as CUR achieves in this case: a fair representation of the taxable business activity in this state for a single taxpayer.

CONCLUSION

It is clear CarMax was more than benignly taking advantage of a corporate structure and South Carolina’s default reporting method. Indeed, it was using intercompany transfer pricing and a partnership with an east-west structure to significantly distort CarMax East’s business activity in

⁷² Indeed, if the Management Fee was reliable and the partnership distributions were arm’s length, I would likely conclude that standard allocation and apportionment fairly represented CarMax’s business in this state.

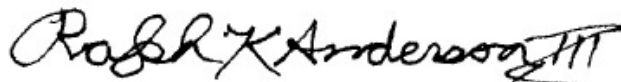
⁷³ To clarify further, I do not read subsection 12-6-2320(A) to require that separate reporting and standard allocation and apportionment must **cause** the unfair representation. It is enough that the business activity is unfairly represented when they are applied.

South Carolina and artificially lower its tax burden in South Carolina without reasonable and reliable justification. Separate reporting, along with standard allocation and apportionment, did not capture or correct this distortion; it shielded it. Under separate reporting, the extent of CarMax East's business activity in South Carolina was not fairly represented during the audit period. § 12-6-2320(A). Under subsection 12-6-2320(A), CUR is an authorized alternative apportionment method. *Media General*, 388 S.C. at 146, 694 S.E.2d at 529. In this case, CUR is a reasonable and equitable alternative method that will correct the distortion and result in a fair representation of CarMax East's business activity in this state. However, because the Department did not complete the application of CUR by applying the *Finnegan* method to divide the taxable income attributable to South Carolina between CarMax East and CarMax West, I find this case must be remanded to the Department to apply *Finnegan*.

ORDER

IT IS HEREBY ORDERED that this matter is **REMANDED** to the Department to divide the South Carolina taxable income under CUR between CarMax East and CarMax West during the audit period pursuant to the *Finnegan* method as described in Revenue Ruling #15-5. The Department will then issue amended assessments to CarMax East and CarMax West for the audit period.

AND IT IS SO ORDERED.

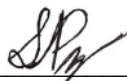


Ralph King Anderson, III
Chief Administrative Law Judge

July 12, 2024
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, Stephanie Perez, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).



Stephanie Perez
Judicial Law Clerk

July 12, 2024
Columbia, South Carolina

RECEIVED

Sep 13 2024

SC Court of Appeals

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc.,	)	Docket No. 21-ALJ-17-0182-CC
	)	
Petitioner,	)	
	)	AMENDED FINAL ORDER
v.	)	
	)	
South Carolina Department of Revenue,	)	
	)	
Respondent.	)	

This matter is before the South Carolina Administrative Law Court (Court) pursuant to a request for contested case filed by CarMax Auto Superstores, Inc., (Petitioner or CarMax East) on June 8, 2019. Petitioner contests the final agency decision of the South Carolina Department of Revenue (Department), in which the Department, following an audit, imposed an alternative apportionment method to assess additional corporate income taxes and interest for fiscal years 2016–2018 (the audit period).¹ As of June 14, 2021, the assessment totaled \$2,224,389.00 for the audit years.²

The Court held a hearing on the merits at its offices in Columbia, South Carolina, from May 23, 2023, through May 26, 2023. Based upon my review of the testimony, the evidence presented, and the parties' arguments, I conclude the Department's decision was correct.

MOTION IN LIMINE AND SUBSEQUENT RULING

On April 21, 2023, Petitioner filed a Motion in Limine to Exclude Expert Testimony Challenging the 2004 Valuation Study (Motion).³ Petitioner sought to exclude certain testimony

¹ The Department imposed the alternative apportionment method known as combined unitary reporting (CUR) pursuant to subsection 12-6-2320(A)(4) of the South Carolina Code (2014).

² This amount does not include any interest or fines that have since accrued.

³ The 2004 valuation study (Valuation Study) was conducted by the accounting firm Ernst and Young (E&Y) for the purpose of valuing the contributions to CarMax Business Solutions, LLC (CBS), a partnership created by CarMax East and CarMax West. I will discuss the genesis of CBS in more detail in the Findings of Fact. For the purpose of understanding the basis for the Motion, it is important to know that CarMax West made a valuable contribution to CBS, which was translated to a large ownership percentage of the partnership based upon values identified in the Valuation Study. The parties dispute whether CarMax West or CarMax East should have been credited with this contribution and received a commensurate ownership percentage in CBS. Ownership percentages are important in this case because, for tax purposes, CBS's profits flow back to its owners proportionate to their



of Dr. David DeRamus, Respondent's expert witness, that would challenge the Valuation Study. Petitioner argued four grounds in its Motion: (1) the Valuation Study is nearly twenty years old; (2) the Department did not challenge the Valuation Study; (3) the Department did not disclose the Valuation Study as a subject of potential expert testimony; and (4) the Valuation Study is not relevant to any issue in the case.⁴

On May 2, 2023, the Court held a conference call on the Motion. During the conference call, the Department admitted it did not directly cite to or challenge the Valuation Study in its determination; however, it argued (1) the transfer prices at issue in this case are intimately tied to the Valuation Study, (2) its expert disclosure was sufficient to put Petitioner on notice that the Valuation Study could be reviewed, and (3) it could challenge the Valuation Study because CarMax East presented the study as support for its position in the case. Petitioner further argued that if testimony on the Valuation Study was allowed, the case should be rescheduled to give it more time to alleviate the prejudice from its admission.

In the Court's view, both parties made valid points. On the one hand, the Department failed to give clear notice that it intended to **specifically** challenge the Valuation Study through its expert or otherwise. Indeed, the Valuation Study was not a proposed exhibit for Dr. DeRamus's deposition. On the other hand, Petitioner's argument that it could not have reasonably anticipated the Department's challenge to the Valuation Study and was wholly unprepared (and therefore prejudiced) to discuss a document it provided in support of its case seemed disingenuous. The Department's determination⁵ and its prehearing statement clearly asserted that

ownership percentages. In this case, whether the partnership distributions distorted CarMax East's taxable income is a central issue in this case.

Thus, Respondent's ability to attack or otherwise challenge the Valuation Study is a central disagreement between the parties and was the subject of this Motion and numerous objections during trial.

⁴ As part of its relevance argument, Petitioner asserted a study from 2004 could not be relevant to an audit for the years 2016-2018. This contention is a thin argument at best. The restructuring of the CarMax group in 2004 affected how money shifted between group members and is therefore relevant in an analysis of whether income shifting is distorting taxable income.

⁵ In its determination, the Department stated: "The Taxpayer alleges that CarMax Group assigned ownership percentages of CBS based on the value of the assets transferred to CBS by CarMax East and CarMax West, respectively. Regardless of whether the ownership percentages are proportionate to the value of the assets contributed at formation of the partnership, those percentages are unrelated to CarMax East and CarMax West's respective business activity in South Carolina." CarMax argues this quote shows that the Valuation Study was not raised as an issue because the Department found that whether the ownership percentages were correct or not did not matter—the extent of CarMax East's business activity in the state was not fairly represented. However, CarMax utilized the study to argue the ownership percentages were justified and the income shifted through the partnership was, therefore, above-board. Therefore, Petitioner brought the Valuation Study into this controversy, ostensibly to

CarMax East shifted most of its federal net taxable income to CarMax West through a partnership with CBS. It also asserted that CarMax West received a 92.5% interest in CBS based upon the valuable assets it contributed to the partnership and CBS thereafter distributed 93.5% of its net income to CarMax West and 6.5% to CarMax East. Thus, even if the Valuation Study was not named, because it supported the assignment of the ownership percentages that allegedly shifted income, it was clearly implicated. Nevertheless, because the Department did not specifically challenge the Valuation Study, the Court orally ruled the Department could not introduce the Valuation Study in its case in chief but could attack it if Petitioner “opened the door.”⁶ The Court declined to reschedule the case.

At the hearing, Petitioner renewed its Motion.⁷ The Court initially upheld its previous oral ruling, but also held the ruling could change based upon the evidence presented. Ultimately, after several continuing objections and discussions, the parties made the Court aware that the Valuation Study had already been admitted as Joint Exhibit 55.⁸ After this revelation, the Court ruled that Petitioner had opened the door to Respondent attacking the 2004 Valuation Study by agreeing, without objection, to admit it as an exhibit.

FINDINGS OF FACT

Having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of proof and the credibility of the witnesses, I make the following findings of fact by a preponderance of the evidence.

say that, yes, the ownership percentages **do** matter and they should be respected. Accordingly, Petitioner does not get to complain that they could not anticipate that evidence they presented would be attacked in an adversarial proceeding. Moreover, the accuracy of the Valuation Study was not the keystone in this case; therefore, if there was any prejudice to Petitioner, it was minimal. The Court found, similar to the Department, that regardless of whether the ownership percentages were justified, the partnership caused income to be shifted from CarMax East to CarMax West with the result that the extent of CarMax East’s taxable income was not fairly represented by standard apportionment.

⁶ On May 8, 2023, after the Court’s ruling on the Motion, the Department filed a response in opposition to the Motion to ensure the record clearly reflected the opposition it expressed in the conference call. In its response, the Department argued it could challenge the Valuation Study because CarMax East presented it as support for its position that an alternative apportionment method is improper in this case. It further argued the subject of the Valuation Study fell within the scope of Dr. DeRamus’s expert disclosure, Dr. DeRamus was qualified to offer testimony on the Valuation Study, and CarMax East deposed him on the subject.

⁷ At the time Petitioner renewed its Motion, the parties did not make the Court aware that the Valuation Study was being introduced as a joint exhibit, which would have affected the Court’s ruling at that time.

⁸ Although it is referred to as the 2004 Valuation Study, the study itself, as demonstrated by Joint Exhibit 55, is dated March 15, 2005. The parties clarified during trial that the 2004 Valuation Study and Joint Exhibit 55 are one and the same.

History of The CarMax Group

CarMax, Inc., (CarMax) began its operations in 1993 under the ownership of Circuit City stores, Inc (Circuit City). At that time, CarMax Auto Superstores, Inc. (CarMax East) and CarMax Auto Superstores West Coast, Inc. (CarMax West) were subsidiaries of CarMax. CarMax East owned the majority of the company’s retail operations, which were located in eastern states. It also performed back-office support functions and finance functions for the company. CarMax West owned the company’s western retail stores and owned the company’s tradenames and trademarks (intellectual property or “IP”).⁹

In 2002, CarMax separated from Circuit City and emerged as a separate publicly traded company. After the separation, CarMax became the parent holding company for three subsidiaries: CarMax East, CarMax West, and Glen Allen Insurance, Ltd. (GAIL). CarMax East continued to hold the majority of the company’s retail operations, back-office support functions, and finance functions.¹⁰ CarMax East also owned its own subsidiaries, including CarMax Properties, LLC (performed real estate functions for the group) and CarMax Auto Funding, LLC (provided financing). CarMax West continued to own the California and Nevada retail operations and also owned the CarMax IP. GAIL was a captive insurance company that provided workers’ compensation and garage liability insurance plans.

In early 2004, CarMax began the process of restructuring its business and employed the firm of Ernst and Young (E&Y) to advise it. In an presentation given on April 6, 2004, CarMax’s Board of Directors (Board) considered consolidating the shared services functions within the group into a new LLC (CarMax Business Services or “CBS”) that would house the headquarters operations, the administrative and decision-making functions, and the company’s financing activities.¹¹ They also considered the benefits of reorganizing the company to provide better legal

⁹ CarMax West has always owned the trademarks and tradenames; they have never been owned by CarMax East. It is unclear who developed the trademarks and tradenames—CarMax East, CarMax West, or the original parent company, CarMax. Nevertheless, CarMax East defended the trademarks and tradenames and developed the marketing and advertising strategies that supported the trademarks and tradenames from at least 2002 until CBS was formed in 2004. Therefore, CarMax East played an important role in maintaining and developing further value for the IP between 2002 and 2004, if not prior to that as well.

¹⁰ CarMax East also owned the “Business Process Intangibles,” such as they were at the time. Of the business process intangibles that existed at the time of the audit—CarMax Book, ASRP, and ACR—only ASRP existed at this time. CarMax Book and ASRP were subsequently developed by CBS after CarMax went through restructuring in 2004.

¹¹ Indeed, having the financing activities located in CAF under CarMax East was causing issues and confusion with regulators. Generally, after a customer purchases a car using financing through a retail installment contracts

protections (isolating its California liability) and to facilitate compliance with new legislation like the Gramm-Leach-Bliley Act.¹² Overall, according to the Board minutes, the Board determined the proposed restructuring would allow CarMax “to realize greater operational, legal and tax advantages than were being realized under the current structure.” The Board approved the restructuring plan; however, it was changed and tweaked over the next several months.

Although most of the restructuring was implemented on December 1, 2004, some parts of the process were implemented before then. On April 23, 2004, CarMax West formed CarMax Business Services, LLC (CBS), a single-member Delaware limited liability company. Thereafter on April 28, 2004, CBS formed CarMax Superstores Services, Inc. (CASS), a Virginia corporation and wholly owned subsidiary of CBS. CASS would later become the holding company for CarMax’s employees. Finally, on May 3, 2004, CarMax West formed CarMax Auto Superstores California, LLC, a single-member limited liability company.

Then, on December 1, 2004, CarMax took the following steps to effectuate the restructuring:

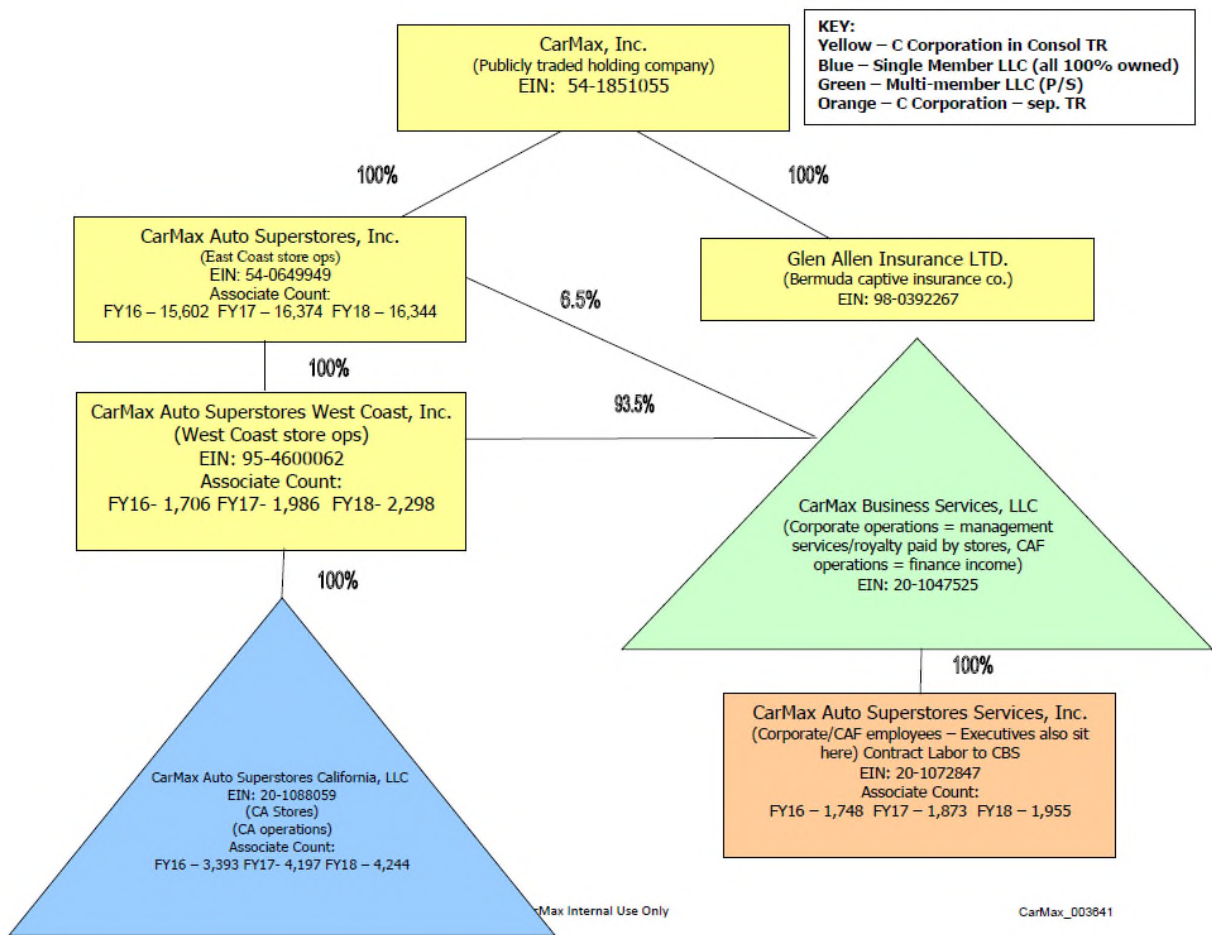
1. CarMax West contributed its California stores to CarMax Auto Superstores California, LLC.
2. CarMax (the parent holding company) contributed 100% of its stock in CarMax West to CarMax East.
3. CarMax East contributed its Business Process Intangibles¹³ and West Creek land to CarMax West.
4. CBS became a partnership and received the following contributions:
 - a. CarMax West contributed the Business Process Intangibles, the West Creek land, and the CarMax IP. In exchange for these contributions, CarMax West received a 93.5% ownership interest in CBS.

(RICs), the RIC is reassigned to a third-party because most dealers do not service their own financing. However, under CarMax’s structure, CarMax East was selling the vehicle and providing direct financing without reassigning its RICs, whereas CarMax West was reassigning its RICs to CarMax East. This arrangement caused confusion and difficulty with regulators. Separating retail sales from financing would clarify each business’s role and the regulations under which it was required to operate.

¹² 15 U.S.C.A. § 6801 (Westlaw).

¹³ According to Petitioner, the “Business Process Intangibles” contributed to CBS were proprietary systems and some trade secrets.

- b. CarMax East contributed the Business Functions (headquarters functions), certain contractual obligations, and some cash. In exchange, CarMax East received a 6.5% ownership interest in CBS.
5. CBS contributed the employee workforce to CASS and entered into an employee servicing agreement with CASS.
6. CBS entered into the Master Management Service Agreement (MMSA) with CarMax East, CarMax West, and CarMax California.
- Thus, after the restructure, CarMax (the CarMax Group) was structured as depicted below:



Master Management Service Agreement

As part of the restructuring, CarMax East, CarMax West, and CarMax California entered into a Master Management Services Agreement (MMSA) with CBS.¹⁴ Under the MMSA, CBS agreed to provide the other members of the agreement with back-office services (legal services, finance and accounting, human resources, information technology, sales operations, and training), real estate services, marketing and advertising services, and quantitative analytics services. In exchange for these services and for managing the IP, CBS charged a Management Fee, which was a flat fee charged per vehicle sold.

Effect of the 2004 Restructuring

From the customer's perspective, the restructuring had no effect on their experience shopping at CarMax. However, internally, the restructuring changed the assigned functions of the different CarMax entities. For example, prior to the restructuring, CarMax East performed the back-office functions. Afterwards, CBS took over those functions.

From a tax perspective, the restructuring had a significant effect because the MMSA and the partnership affected the flow of income between the companies. Specifically, because CBS is structured as a partnership, it is not directly taxed. Rather, the income it generates flows back to its partners—CarMax East and CarMax West. Therefore, whatever income CBS earns, through the MMSA and otherwise, is distributed back to CarMax East and CarMax West for tax purposes. Based upon the assigned ownership percentages of CBS, CarMax West receives 93.5% of CBS's income and CarMax East receives 6.5% of CBS's income.

The effect of this structure during the audit period is stark. During this period, CBS generated about half of its income from the Management Fees it charged CarMax East and CarMax West. Since CarMax East was the owner and operator of the vast majority of the retail stores (approximately 75%), it was the source of the majority of CBS's income from the Management Fees. Nevertheless, because CarMax West was assigned a 93.5% interest in CBS during the restructuring (primarily due to its contribution of the business process intangibles), almost all of CBS's income flowed back to CarMax West, which only originated approximately 25% of CBS's Management Fee income. Thus, as a result of the flow of income through the

¹⁴ Collectively, CarMax East, CarMax West, and CBS are the CarMax entities primarily at issue in this litigation and the parties do not dispute that they make up a unitary group.

partnership, CarMax's East taxable income significantly decreased while CarMax West's taxable income significantly increased. More specifically, CarMax East generated about 75% of the Group's revenues but was only attributed with about 20% of the Group's taxable income because the rest of its revenue that would have become taxable income was shifted to CarMax West. In contrast, CarMax West only produced 25% of the Group's revenues but was attributed with about 80% of its taxable income.

Unsurprisingly, the combined effect of the Management Fee and the partnership distributions also significantly reduced CarMax East's South Carolina taxable income. Over the course of the three audit years, CarMax East's South Carolina stores had a total operating profit of approximately \$90,000,000; however, their taxable income apportioned to South Carolina was only about \$21,000,000. The delta between these values reflects the movement of income from CarMax East to CarMax West through the Management Fee and the partnership terms.

The CarMax Business During the Audit Period¹⁵

During the audit years, CarMax held itself out as the largest retailer of used cars in the United States.¹⁶ It competed with franchised dealers selling new and used cars, independent used cars dealers, online and mobile sales platforms, and private parties. CarMax East and CarMax West owned and operated 188 retail stores by the end of the audit period. CarMax East owned 75% of those stores (141), including four stores in South Carolina by the end of the audit period. CarMax West did not own any stores in South Carolina.

Business Model

CarMax's goal was "to deliver unrivaled customer experience by offering a broad selection of high quality used vehicles and related products and services at low, no-haggle prices using a customer-friendly sales process in an attractive, modern sales facility." Its competitive strategy was to address customer dissatisfaction with traditional methods of retail in the auto industry, including high pressure sales tactics and unclear pricing.

¹⁵ Generally, the information in this section is from CarMax's 10-K for FY2016. A review of CarMax's 10-Ks from FY2017 and FY2018 showed no significant changes to its business model for the purpose of this case.

¹⁶ At the time of the audit, CarMax sold new vehicles at two locations under franchise agreements, but new vehicles were not the focus of its business or the primary source of its income. Generally, CarMax focused on selling used vehicles from 0-10 years old that had less than 100,000 miles.

To create a low-pressure sales atmosphere for the customer, CarMax associates were generally paid a fixed commission per vehicle to negate the need for up-selling and to retain focus on the customers' needs. Additionally, each aspect of CarMax's sales business had a discrete, transparent cost for the customer, so the customer could choose which transaction(s) he wished to pursue. For example, customers could sell their cars to CarMax through CarMax's "appraisal lane" with or without purchasing a "new" used car from CarMax.¹⁷

CarMax also strove to differentiate its sales by providing its customers with access to its national inventory through its website and mobile app. For example, in FY2016, CarMax had over 55,000 cars available in its national inventory. If a customer found a car they wanted in the national inventory, CarMax would transfer the vehicle to the customer's local store at the customer's request.

Sales

Over the course of the audit period, CarMax was a profitable company with healthy operating margins. During this time, CarMax East sold about 1.5 million vehicles, which equated to about 75% of the Group's sales. Also, CarMax East and CarMax West sold extended protection plans (EPPs). These plans included extended service plans (ESPs)¹⁸ and guaranteed asset protection (GAP) coverage. CarMax estimated that in FY2016, more than 60% of its customers purchased an ESP and about 25% purchased GAP coverage.

Financing

CarMax provided financing to its customers through its subsidiary, CarMax Auto Financing (CAF), which was owned by CBS. CAF used proprietary scoring models to analyze customers' credit histories and predict the likelihood of a customer payment for the purpose of offering financing directly through CAF or through its third-party financing partners. CAF serviced all the loans it originated during the audit years.¹⁹ In FY2016, CAF serviced approximately 704,000 customer accounts in its \$9.59 billion portfolio of managed receivables.

¹⁷ According to CarMax, during the audit period less than fifty percent of the vehicles it purchased in its appraisal lane met its retail standards. As a result, it developed a large wholesale operation wherein the vehicles that did not meet its standards were sold to licensed dealers through its on-site wholesale auctions. Wholesale sales were a significant part of CarMax's business.

¹⁸ Customers who purchased ESPs could have their vehicle serviced at local CarMax stores or at thousands of independent and franchised service providers.

¹⁹ About once a quarter, CAF will bundle a group of loans, securitize them, and sell them on the public market. However, CAF remains the servicer of these loans.

CAF generated the bulk of its income from the interest it collected on car payments; however, it also made some income off of late fees, etc. Financing income accounted for roughly 25% of the company's gross profits each year of the audit. The finance business was successful, in part, because it has a high profit margin.

Financing Process

CarMax did not have finance managers at the retail stores. Rather, retail store employees assisted customers in submitting credit applications online for financing. Then, CAF and CarMax's third-party financing partners reviewed the applications to determine whether the customers were eligible for financing. A financing offer was then electronically returned to the local store employees who presented the financing options to the customers. After the customers selected a financing option, the employees assisted the customers with filling out the paperwork for the financing, known as a retail installment contract (RIC). Once complete, the RICs were assigned from the local store to either CAF or the third-party lender. Notably, CAF, through CBS, did not pay the local stores an origination fee for the loans they initiated.

CBS's Back-Office Services

As explained above, CBS provided several back-office services to CarMax East and CarMax West during the audit period. These services included legal services, finance and accounting, human resources, information technology, sales operations, training, real estate services, marketing and advertising services, and quantitative analytics services. CBS also owned and managed the trademarks for CarMax. CBS was compensated for these services through a flat, per car Management Fee under the MMSA. CBS also owned and managed CAF.

CBS was profitable during the audit period. About half of CBS's income came from the Management Fees it collected under the MMSA and about half of its income came from CAF's financing business. Over the three audit years, CBS had a total income of approximately \$2 billion. Because CBS is a partnership owned by CarMax East and CarMax West, its income was ultimately sourced back to CarMax East and CarMax West in proportion to their ownership interests for the purpose of taxation.

Trademarks and Tradenames

During the audit years, CBS owned CarMax's IP. It was responsible for monitoring the trademarks and tradenames, sending cease and desist letters, and applying for patents. CBS hired

third-parties, as needed, to assist it with these duties. CBS licensed the IP to CarMax East and CarMax West through the License Agreement. Under the License Agreement, in exchange for the use of the IP, CarMax East and CarMax West agreed to pay CBS a license fee, pursuant to the MMSA, as part of the Management Fee.

Marketing and Advertising

CBS owned and operated CarMax's website and was responsible for marketing and advertising for CarMax. For example, it was responsible for media buying, broadcast media, commercials, and creative work. It was also responsible for market analytics and customer insight surveying.²⁰ The retail stores also engaged in some of their own advertising and were responsible for executing the retail strategies developed by CBS.

CarMax's advertising strategy focused on developing awareness of the advantages of shopping at its local stores and at carmax.com. CarMax used traditional and digital methods to advertise, including social media. It provided detailed, sophisticated search engines for customers to navigate its website to find the right vehicle. According to CarMax, approximately 88% of its customers who purchased a vehicle had first visited CarMax online. CBS also contracted with an external firm, Horizon Media, to plan and place some of CarMax's advertising, including local and national television, radio, digital, and outdoor media (billboards, e.g.).

Real Estate Services

CBS housed the real estate services department, which was responsible for acquiring property for the stores and ensuring the stores were properly permitted and zoned. The real estate team was also responsible for property management after stores were opened. This department also worked with other strategic teams at CBS, like marketing and advertising, to engage in expansion planning.

²⁰ The MMSA outlined CBS's specific advertising and marketing duties, which included: performing market analysis for potential locations; market research to distinguish CarMax; market analysis on test drives and purchase; "enterprise-wide" marketing strategies; developing campaigns, promotions, and advertisements; procuring all television, print, radio, and online advertising; creative development of the website, direct marketing campaigns, developing names, logos, slogans, tradenames, etc.; and providing specific decision making guidance to local stores.

Quantitative Analytics Group

CBS's quantitative analytics group (data science team) developed proprietary systems to assist with several aspects of CarMax's business—like pricing and reconditioning.²¹ These proprietary systems are also known as “business process intangibles.” CarMax asserts its proprietary systems drove much of the company's value generation.²²

Three propriety systems were specifically identified at trial: ASRP, CarMax Book, and ACR (appraisal cost recovery).²³ CarMax first developed the ASRP system around 2003, before CBS's creation. It uses this system to price approximately 90% of the cars on its lots. Then, CBS developed CarMax Book, which functions like Kelly Blue Book. CarMax has used this system since approximately 2011 to identify the most lucrative price to pay for a used car at auction.²⁴ Finally, CBS developed ACR to price cars in its appraisal lane to boost its gross margins. CarMax is currently on its ninth or tenth iteration of ACR.

The goal of all these systems was to improve margins; then, the executive team would determine if the extra margins should be realized as profit or through lowering the customer's price. Thus, while the retail stores ultimately brought in revenue for CarMax through sales, many of the decisions underlying the sales—like how to price a car or how much to pay for a car—were guided by the proprietary systems developed by CBS.

²¹ Specifically, under the MMSA, CBS agreed to provide the following “analytical and business development services”: develop algorithms to enhance the efficiency and profitability of the business; capture and analyze data from across all lines of business to develop proprietary formulas to enhance inventory buying and management functions; capture and analyze data to develop proprietary formulas to enhance the inventory mix and obtain maximum profitability; provide specific decision making guidance with respect to which vehicles to purchase, including information as specific as the model, make, year, mileage, options, and overall condition.

²² CarMax also asserts that it considered outsourcing the data systems work in the past, but ultimately determined it was more advantageous to keep this service in house.

²³ For example, the quantitative analytics group deployed A/B testing. In this testing type, some stores (A stores) applied a newly developed algorithm for how to handle the decision to re-paint a car, and some stores (B stores) did not apply the algorithm. The quantitative analytics group then analyzed the profits from each decision type, A or B, to determine if the algorithm improved margins. As a result of this testing, CarMax implemented a decision tree about when and how to re-paint a car.

²⁴ CBS developed several iterations of CarMax Book and tested them across auctions and regions until CarMax Book outperformed human buyers.

CarMax's Business Activity in South Carolina

During the audit period, CarMax East's business activity in South Carolina was selling and purchasing cars as well as the sale of EPPs. CarMax East had three stores located in South Carolina for most of the audit period and added a fourth store at the end of the audit period.

CarMax West had no business activity in South Carolina except through its 93.5% ownership interest in CBS. CarMax West was taxed on CBS's South Carolina income that flowed through the partnership back to CarMax West.

CBS's business activity in South Carolina was related to its licensing of CarMax's trademarks and tradenames and financing income from loans that originated in South Carolina. CBS's income was recognized on CarMax East's and CarMax's West's respective South Carolina tax returns.

CarMax East's Tax Returns

For all tax years at issue, CarMax East filed its tax returns using South Carolina's standard method of separate reporting. I will use FY2016 as an example. In FY2016, CarMax East reported \$167,235,618 in taxable income on its South Carolina tax return, which is the amount of federal taxable income attributed to CarMax East (the Group's federal taxable income was \$835,068,258).²⁵ After South Carolina's modifications, that figure increased to a net taxable income of \$208,904,788. Then, net taxable income (\$208,904,788) was multiplied by a sales factor of 3.35%²⁶ to apportion the amount of net taxable income attributable to South Carolina. This resulted in a taxable base of \$7,010,427. South Carolina's corporate tax of 5% was then applied to arrive at a corporate income tax of \$350,521. The same method was used for the other audit years.

CarMax West's Tax Returns

CarMax West similarly filed its taxes using separate reporting for all the tax years at issue. In FY2016, CarMax West paid \$109,407 in taxes. In total, it paid \$369,104 in taxes during the audit period and had an average sales factor of 0.33%. The sales factor's numerator included

²⁵ Importantly, although CarMax East had the majority of revenue and sales for the Group in this year, its apportionment of federal taxable income (\$167,235,618 out of \$835,068,258) is remarkably low as a result of the income shifting from CarMax East to CarMax West through the Management Fee and partnership distributions.

²⁶ The sales factor was equal to CarMax East's South Carolina sales in 2016 (numerator) divided by its sales everywhere (denominator).

CarMax West's South Carolina retail sales (\$0), 93.5% of CBS's royalty receipts from South Carolina, and 93.5% of CBS's finance receipts from South Carolina. The denominator included all of CarMax West's retail sales everywhere, 93.5% of CBS's royalty receipts from everywhere, and 93.5% of CBS's finance receipts from everywhere.

Department Determination

In its Determination, the Department concluded that for the audit years (FY2016-2018) the use of separate reporting and the standard apportionment method did not fairly represent the extent of CarMax East's business activity in South Carolina.²⁷ It further concluded that combined unitary reporting (CUR) was a reasonable alternative apportionment method pursuant to subsection 12-6-2320(a)(4) of the South Carolina Code. Pursuant to subsection 12-6-2320(a), the Department required CarMax East to use CUR for the audit years, which increased CarMax East's South Carolina taxes.

Underlying the Department's imposition of CUR was its factual determination that CarMax East "shifted most of its federal net taxable income to CarMax West via a partnership with CBS and the resulting apportionment did not fairly represent the extent of [CarMax East's] business activity in South Carolina." The Department further found that CarMax qualified for CUR under two of the three circumstances in which the Department applies it: (1) the existence of a management fee and (2) an east-west business structure.

Specifically, the Department determined CarMax utilized CBS's Management Fee to shift income from CarMax East to CarMax West through CBS. It found:

Despite only receiving 6.5% of the net income earned by CBS, CarMax East paid more than 74% of the total management fee to CBS during the Periods at Issue. This shifts CarMax East's income to CBS, who then distributes 93.5% of its receipts to CarMax West. Even if the management fees paid to CBS are proportionate to the management services provided, the difference in distributive shares shifts a disproportionate amount of income to CarMax West.

The Department further found that "[r]egardless of whether the ownership percentages [in CBS] are proportionate to the value of the assets contributed at formation of the partnership, those percentages are unrelated to CarMax East and CarMax West's respective business activity in South Carolina." Moreover, "[b]ecause the shifting is not based on the extent of CarMax East's

²⁷ The Department audited both CarMax East and CarMax West; however, only CarMax East was included in this action.

business activity, the result is not a fair representation of [CarMax East's] business activity in South Carolina.”

The Department calculated that through intercompany transactions, CarMax East reduced its federal taxable income by \$1.6 billion for the audit period while CarMax West increased its federal taxable income by \$1.4 billion. As a result, CarMax East had a net taxable income return of \$10.54 for every \$100 of income it produced while CarMax West had a net taxable income return of \$57.00 for every \$100 of income it produced. In other words, the Department calculated that although CarMax West produces much less revenue than CarMax East, CarMax West's income produces 541% more federal taxable income than CarMax East's because the Management Fee and partnership distributions siphon income from CarMax East to CarMax West.

As a result of its audit, the Department imposed CUR. Under CUR, the Group's federal taxable income—\$835,068,258—was modified to arrive at a South Carolina net taxable income of \$903,584,022. The sales factor was then adjusted for CUR such that the numerator was the Group's South Carolina sales and the denominator was the Group's sales everywhere. In 2016, this resulted in a sales factor of 2.507%. Multiplying the sales factor by net taxable income (\$903,584,022) resulted in a taxable base of \$22,652,851. The Department then applied the corporate income tax rate of 5% to arrive at an audited corporate income tax equal to \$1,132,643. The same method was used for the other audit years.

With the application of CUR, CarMax East owed additional taxes in South Carolina for each audit year. The following amounts are at issue:

Period Ended	02/28/16	02/28/17	02/28/18	Total
Tax	\$672,715.00	\$760,060.00	\$791,614.00	\$2,224,389.00
Interest*	\$149,876.59	\$129,965.49	\$92,476.89	\$372,318.97
Total	\$822,591.59	\$890,025.49	\$884,090.89	\$2,596,707.97

*The interest amount has been updated from the Proposed Assessment and is computed through June 14, 2021, and will continue to accrue until this matter is resolved.

Although CarMax disagreed with the Department's imposition of CUR, it agreed the Department correctly calculated CarMax East's tax liability under CUR.

A comparison of the two reporting methods is illustrated in the table below:

	CarMax East's South Carolina Tax Return for FY2016	Department's Use of CUR for FY2016
Line 1 ²⁸ – Federal Taxable Income	\$159,609,689	\$835,068,258
Line 2 – Net Adjustment (i.e., state law adjustments)	\$49,295,099	\$68,515,764
Line 3 – Total Net Income as Reconciled (i.e., total income subject to apportionment) ²⁹	\$208,904,788	\$903,584,022
Apportionment Ratio	3.36%	2.51%
Line 4 – Total SC Net Income	\$7,010,427	\$22,652,851
Line 5 – Net Operating Losses	\$0	\$0
Line 6 – SC Net Income Subject to Tax	\$7,010,427	\$22,652,851
SC Corporate Tax Rate	5%	5%
Line 7 – Corporation Tax Due	\$350,521	\$1,132,643
Credit for Tax Paid by CarMax East	N/A	(\$350,521)
Credit for Tax Paid by CarMax West	N/A	(\$109,407)
Total Combined Credit for Taxes Paid	N/A	(\$459,928)
Additional Tax Owed by CarMax East	N/A	\$672,715

Valuation of CBS's Partnership Interests

Although the Department, in its determination, found that “[r]egardless of whether the ownership percentages [in CBS] are proportionate to the value of the assets contributed at formation of the partnership, those percentages are unrelated to CarMax East and CarMax West’s respective business activity in South Carolina,” CarMax submitted evidence to support CBS’s partnership distributions.

The distributions were set based upon the relative value that CarMax East and CarMax West contributed to the partnership at its formation. Specifically, CarMax East contributed the back-office functions, CAF, and some cash. CarMax calculated these contributions had a net book value (NBV) and a fair market value (FMV) of \$120,510,723. Next, CarMax West contributed the West Creek property, the CarMax IP, and the business process intangibles.

²⁸ References to line numbers correspond to the line numbers on Form SC1120 (South Carolina corporate income tax return).

²⁹ The amount on Line 3 is the net taxable income subject to allocation and apportionment in South Carolina. No income is allocated in this case, and thus the amount on Line 3 (in both columns) represents the total net income subject to apportionment.

CarMax determined the West Creek property to have a NBV and FMV of \$11,260,301, and, based upon the 2004 Valuation Study conducted by E&Y, CarMax assigned a FMV of \$1,996,000,000 to the IP and the business process intangibles. In total, the FMV of CarMax West's contributions totaled \$2,007,270,301.

Based upon the above valuations—\$120,510,723 and \$2,007,270,301 respectively—CarMax East contributed 6.5% of the value to CBS and CarMax West contributed 93.5% of the value to CBS. Accordingly, CarMax assigned CarMax East a 6.5% interest in CBS and CarMax West a 93.5% interest in CBS. The value contributed by CarMax West was primarily in the business process intangibles and IP. Thus, to support its valuation of the IP and business process intangibles, and thus the assignment of the 93.5% interest to CarMax West, Petitioner submitted E&Y's 2004 Valuation Study, which was the subject of its Motion in Limine.

Similar to the Department, I ultimately find that regardless of whether the Valuation Study is accurate or correct, the resulting shifts in income between the CarMax Group result in CarMax East's business activity in South Carolina to not be fairly represented. Nevertheless, since the parties introduced a substantial amount of testimony surrounding the Valuation Study, I address it.

The Valuation Study was based upon principles in the "482 Regulations." Therefore, before I address the study, a brief overview of the "482 Regulations" is necessary. This background is also necessary for a discussion of the transfer pricing studies introduced by the parties concerning the Management Fee, which will be discussed later.

482 Regulations

The 482 Regulations are derivatives of section 482 of the Internal Revenue Code, which gives the IRS the authority to reallocate income between related parties to prevent tax evasion.³⁰ 26 U.S.C.A. § 482 (Westlaw through Pub. L. 118-3) ("Allocation of income and deductions among taxpayers"); *see Sundstrand Corp. & Subsidiaries v. Comm'r*, 96 T.C. 226, 353 (1991) ("The purpose of section 482 is to prevent the artificial shifting of the net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers.").

³⁰ South Carolina has adopted section 482, and the Department has the authority, like the IRS, to apportion or allocate income to prevent the evasion of taxes or to clearly reflect the income of an organization. *See* S.C. Code Ann. § 12-6-40 (2104 & Supp. 2023) (adopting the Internal Revenue Code to state tax laws); S.C. Code Ann. § 12-54-155 (2014) (discussing the application of section 482 in the context of a "substantial valuation misstatement").

The process of allocating income between related parties is called transfer pricing. More specifically, transfer pricing is the process by which companies assign prices to transactions between related parties (controlled taxpayers) to mimic the prices between unrelated parties (uncontrolled taxpayers) on the open market.³¹ Because transfer pricing shifts income between related parties, it is possible for companies to abuse transfer pricing to artificially shift income from a higher tax jurisdiction to a lower tax jurisdiction. Accordingly, taxing authorities pay close attention to transfer pricing.³²

Because section 482 consists of only one paragraph, transfer pricing experts rely on the “482 Regulations” for guidance on how to calculate and evaluate transfer prices consistent with the IRS’s standards. 26 C.F.R. § 1.482-0 to -9 (Westlaw). The 482 Regulations contain several principles to consider when analyzing related party transactions, including the arm’s length principle and the economic substance of the transaction. 26 C.F.R. § 1.482-1(a)(1) (Westlaw through 89 F.R. 51276). The overarching objective of transfer pricing is to place the controlled taxpayer in parity with an uncontrolled taxpayer.

Arm’s Length Principle

Pursuant to the arm’s length principle, the price between two controlled taxpayers should reflect the price to which two uncontrolled taxpayers would agree on the open market. 26 C.F.R. § 1.482-1(b) (“A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result).”). The arm’s length principle does not necessarily require a single correct price for a transaction, but generally seeks to identify a range of prices that one would expect to see in the open market. 26 C.F.R. § 1.482-1(e) (“In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm’s length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived.”). If the

³¹ “Controlled taxpayer means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. Uncontrolled taxpayer means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.” 26 C.F.R. § 1.482-1(i)(5) (Westlaw through 89 F.R. 51276).

³² This is not to say that tax minimization strategies are either improper or not a part of good business and tax advice. Yet, to pass judicial muster, transfer pricing must be consistent with dealings in an open market. Moreover, the “establishment of a business purpose for a transaction does not necessarily insulate the taxpayer from a section 482 allocation.” *Sundstrand Corp. & Subsidiaries v. Comm’r*, 96 T.C. 226, 353 (1991).

price of a controlled transaction falls outside of the arm's length range, the IRS may reallocate income and adjust the price to fall within the range—usually, the IRS adjusts the price to the range's median. 26 C.F.R. § 1.482-1(e)(3).

Economic Substance

Economic substance refers to whether the purported purpose of the transaction aligns with how the parties are actually behaving in the transaction—whether substance matches form. How the parties represent themselves legally and contractually will be respected unless there is no economic substance to the transaction. 26 C.F.R. § 1.482-1(d)(3)(ii).

In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (see, for example, § 1.482-4(f)(3) (Ownership of intangible property)). If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Id.

Functional Analysis

The 482 Regulations contain several different methods for pricing controlled transactions. 26 C.F.R. § 1.482-3 to -6 (Westlaw). Whether a certain method should be used depends upon the nature of the transaction—does it involve a good or a service or the licensing of an intangible? Who is bearing the risk in the transaction? In other words, before an appropriate method can be chosen, the transaction must have context, and this is accomplished through a functional analysis.

The result of the functional analysis not only guides the method to be used, but also the choice of comparable transactions from which a transfer price can be obtained. 26 C.F.R. § 1.482-1(d)(3)(i) (instructing that the degree of comparability between controlled and uncontrolled transactions requires a functional analysis). A functional analysis should include a comparison of “the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions” and “consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles.” 26 C.F.R. § 1.482-1(d)(3)(i).

The Best Method Rule

Once the functional analysis is complete, the analyst chooses a pricing method pursuant to the “best method rule.” The best method rule requires the analyst to use whatever transfer pricing method is the most reliable method based on the facts and circumstances of the transaction. 26 C.F.R. § 1.482-1(c).³³ Generally, each method compares the controlled transaction with similar uncontrolled transactions (comparables) to determine an arm’s length price range. The more similar the uncontrolled transactions—the higher the comparability—the more accurate and reliable the method will be. 26 C.F.R. § 1.482-1(c)(2)(i) (“The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables . . .”).

Comparability

Depending upon the selected pricing method, higher or lower degrees of comparability may be required to reach a reliable arm’s length result. Generally, “[i]n order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm’s length result.” 26 C.F.R. § 1.482-1(d)(2). “If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results.” *Id.*

Data Accuracy and Completeness

The completeness and accuracy of the data available to analyze the controlled and uncontrolled transactions affects the overall reliability of a given method. 26 C.F.R. § 1.482-1(c)(2)(ii). “Deficiencies in the data used or assumptions made may have a greater effect on some methods than others” and “the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction.” 26 C.F.R. § 1.482-1(c)(2)(ii)(C). A good test of reliability is whether two different methods produce consistent results. 26 C.F.R. § 1.482-1(c)(2)(iii).

³³ Choosing the best method is important because even if a method appears to follow logical steps, if it produces a result that is not reliable in the particular circumstance, then it is not the best method.

Expert Testimony

To assist the Court in evaluating the related party transactions at issue in this case, including the transfers underpinning the formation of CBS, the parties presented expert testimony. On behalf of Petitioner, Dr. Brian Joseph Cody was qualified as an expert in economics and transfer pricing. Dr. Cody has a PhD in economics. During his approximately fourteen years at the firm KPMG, Dr. Cody led the Chicago transfer pricing group, then oversaw the Western region transfer pricing, economic, and valuation services group, and finally, he headed the economic and valuation services group for KPMG's national office. Dr. Cody spent the last twenty years of his career working predominantly within the retail industry, including leading KPMG's retail and consumer product transfer pricing group.

On behalf of the Department, Dr. David Watlington DeRamus was qualified as an expert in transfer pricing, including economic principles. Dr. DeRamus was also qualified as an expert in valuation. Dr. DeRamus has a PhD in economics. He currently works for the economic consulting firm Bates White. He previously worked at other firms, including KPMG, many years ago. He describes himself as an applied micro economist who studies the factors that lead companies to either have high or low profits. He has performed valuation analyses for asset transfers, particularly for intangible assets, over the course of his thirty-year career.

I did not find either expert to be completely convincing. Dr. Cody's work has been heavily concentrated in domestic retail transfer pricing, like the matter before the Court. Nevertheless, despite his experience in retail, I did not find his explanations of several transactions to be rigorous or convincing. In contrast, Dr. DeRamus's work has been mostly associated with international companies and the energy sector, including utilities involving the Federal Energy Regulatory Commission. However, he testified in much more detail and with a rigor and reason that made him more persuasive in several areas. Therefore, I have made my factual analysis based upon the aspects of each expert's testimony I found convincing. *See Small v. Pioneer Mach., Inc.*, 329 S.C. 448, 470, 494 S.E.2d 835, 846 (Ct. App. 1997) ("Where the expert's testimony is based upon facts sufficient to form the basis for an opinion, the trier of fact determines its probative value."); *see also Altama Delta Corp. v. Comm'r*, 104 T.C. 424, 465–66 (1995) ("We are not bound by the opinion of any expert witness, but will consider that opinion based on our analysis of the evidence in the record and applying our judgment in consideration of that evidence."); *id.* ("While we may choose to accept the opinion of one expert in its entirety, we

may also be selective in the use of any portion of that opinion.”). With this background in mind, I now turn to E&Y’s Valuation Study and the experts’ opinions of it.

E&Y 2004 Valuation Study

Based upon E&Y’s 2004 Valuation Study, CarMax West was assigned its large interest in CBS’s partnership, the validity of which is now at issue in this case. In the Valuation Study, CarMax tasked E&Y to value its “Car business-related intellectual property owned by CarMax as of December 1, 2004” or “car-related IP.” The “car-related IP” included CarMax’s IP and its business process intangibles.³⁴ The purpose of the study was to assign value to the transfer of these intangibles from CarMax West to CBS during the restructuring.

Since the transfer of the car-related IP to CBS involved intangibles, E&Y utilized § 1.482-4 of the 482 Regulations, which governs the transfers of intangibles. 26 C.F.R. § 1.482-4 (Westlaw through 89 F.R. 41848). This section instructs that “[t]he arm’s length consideration for the transfer of an intangibles determined under this section must be commensurate with the income attributable to the intangible.” 26 C.F.R. § 1.482-4(a). Additionally, this section requires the use of one of four specified methods: (1) the comparable uncontrolled transaction method (CUT); (2) the comparable profits method (CMP); (3) the profit split method (PSM); or (4) an unspecified method (UM). *Id.* E&Y determined the best method to apply was the UM.³⁵ Specifically, they applied a UM known as the discounted residual cash flow (DRCF) method.

Under the DRCF method, the analyst calculates projections for the business’s free cash flows, discounts those projections, and then subtracts from the sum of those discounted projections the value of the parts of the business not being transferred. Thus, E&Y essentially calculated the value of the whole CarMax business and then subtracted the value of the company’s various components until only the “residual” value of the car-related IP remained.

³⁴ Importantly, the study was limited to “car-related” intangibles; it did not attempt to value intangibles related to CarMax’s financing operations or real estate leases.

³⁵ E&Y rejected the CUT method because there were no sufficiently similar uncontrolled transactions from which to ascertain an arm’s length transfer price. E&Y stated: “Given the highly specific, if not unique, character of CarMax’s relevant intangibles, it is difficult if not impossible to identify external comparables which could serve as the basis for this analysis.” They further determined “[a]lthough there are external examples of some portion of the intangibles being licensed, such as the trademark, E&Y was unable to identify any publicly available external agreements/transactions that involved the sale or license of intangibles similar to all of the intangibles being transferred as part of this transaction.” Similarly, E&Y rejected the CMP and PSM for lack of suitably comparable royalty agreements in uncontrolled transactions to use as benchmarks.

A weakness of the DRCF method is its reliance on assumptions to forecast free cash flows. However, E&Y believed this weakness was mitigated “to a considerable degree.” E&Y validated CarMax’s internal projections to their satisfaction such that E&Y determined its estimate could “be considered reliable.”

Initially, E&Y estimated and eliminated the value of the CAF-related business and cash flows from the value of the whole business to arrive at value of \$2,744 million. Then, E&Y eliminated the value of the net working capital,³⁶ the PPE,³⁷ and the retail store leases associated with the business (\$374 million, \$367 million, and \$7 million respectively). After these values were eliminated, the residual value attributed to the car-related IP was approximately \$1.996 billion.³⁸

E&Y corroborated its result by calculating the value of the company as a whole using the Market Capitalization (MC) method. This method valued the company based upon the value of the company’s stock minus its liabilities. The variability of stock prices lessens the reliability of this method. Nevertheless, E&Y found the value of the company as calculated by the two methods was very similar (\$3.017 million under DRCF and \$2.932 million under MC). This similarity, in E&Y’s opinion, gave credibility to its valuation of the car-related IP under the DRCF method.

Dr. Cody’s Opinion

Dr. Cody did not give an opinion on E&Y’s 2004 valuation study because he did not feel qualified to do so. Even though he has worked with intangibles and has valuation experience, E&Y’s methodology and adjustments were beyond the scope of what he would normally do as a transfer pricing professional. According to Dr. Cody, transfer pricing teams include valuation experts who have specific training in accounting and financial statement analysis compared to economists. Therefore, he would have sought the advice of a valuation expert on his team to assess E&Y’s study.

³⁶ Net working capital represents the difference between a company’s assets and liabilities.

³⁷ PPE refers to a company’s property, plants, and equipment.

³⁸ E&Y did not determine what portion of the \$1.996 billion was attributable to the IP versus the business process intangibles. However, the relative value of the IP and the business process intangibles was determined for the purposes of the MMSA, which I will discuss in detail below. Based upon the valuations calculated for the MMSA, the IP represents a small fraction of the \$1.996 billion figure E&Y calculated. Therefore, most of the value is derived from the business process intangibles.

Dr. DeRamus's Opinion

Dr. DeRamus found the DRCF method to be unreliable in this instance because a large portion of the data that was used to value the intangibles was internal and forecasted data. He also questioned whether the residual cash flow should have been attributed to the business process intangibles or whether economies of scale or some other intangible was driving the value. Further, in his opinion, E&Y did not allocate enough of the residual cash flow to the CAF function, which would significantly decrease the value of the business process intangibles.

Although Dr. DeRamus's testimony suggested E&Y's method over-valued the business process intangibles, he also observed that the business process intangibles were one of the most valuable parts of the business according to CarMax's own valuation of them for the purpose of calculating the Management Fee. Because the business process intangibles were so valuable, he found their transfer from CarMax East to CarMax West for zero compensation during the restructuring was not an arm's length transaction. Dr. DeRamus explained that based upon the valuation of the business intangibles at \$1.996 billion,³⁹ he would have expected CarMax West to pay CarMax East this amount in exchange for receiving the business intangibles, but it did not.

In response to this testimony, Dr. Cody asserted that CarMax East received compensation for the transfer of the business process intangibles to CarMax West because CarMax East owned 100% of CarMax West and benefited from the increase in CarMax West's stock value.

Conclusion

Based upon E&Y's Valuation Study, CarMax's valuation of the partnership contributions, and the experts' opinions, I conclude the Department's evidence was insufficient to establish whether the Valuation Study was accurate. Dr. DeRamus's concerns about forecasted data are reflected in the 482 Regulations, which caution against using internal company data and forecasted data because it can be less reliable. 26 C.F.R. § 1.482-4(d) ("[I]n accordance with § 1.482-1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used."). Here, E&Y relied heavily on internal company data and forecasting that I found questionable, and then relied on notoriously unreliable stock market data to corroborate

³⁹ The Court notes that this value also includes the CarMax IP.

its results. Therefore, based upon the evidence, the **reliability** of the study is diminished. However, simply because a methodology is less reliable does not mean that its result is incorrect; therefore, I cannot find the Valuation Study was incorrect. Regardless, even if the Valuation Study is correct, it merely supports the fact that the “car-related IP,” and primarily the business process intangibles, were very valuable assets. While the parties quibbled about how valuable the business process intangibles were for the purpose of the Management Fee, they both agreed they were valuable assets. Therefore, whoever contributed these assets to CBS deserved credit for them.

Regarding the partnership distributions more generally, I conclude the evidence shows that CarMax East should have received credit for the contribution of the business process intangibles to CBS and should have received a commensurate portion of the CBS partnership. Specifically, during the restructuring, CarMax East transferred the business process intangibles to CarMax West for zero compensation. Under the 482 Regulations, the transfer of these intangibles for zero compensation would be a non-arm’s length transaction. 26 C.F.R. § 1.482-1(b)(1) (“A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result).”). It would be a non-arm’s length transaction because, if CarMax East was in an open market, it would have never given away its very valuable business process intangibles for zero compensation and then agreed to pay a large fee for the use of those same intangibles through the MMSA. *See id.* Rather, CarMax East would have evaluated its reasonable alternatives, including retaining the business process intangibles or selling them for an arm’s length price. 26 C.F.R. § 1.482-1(f)(2)(ii)(A) (providing “the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances” and adjust the consideration charged accordingly).

Petitioner presented evidence through Dr. Cody that because CarMax East owned CarMax West, it gave away nothing when it transferred the intangibles to CarMax West and, CarMax East received compensation in the form of CarMax West’s increased stock value. I did not find Dr. Cody’s testimony to be persuasive. There was no evidence that CarMax West, as a member of the group and child to the parent company, is individually traded on the stock market.

Nor did Dr. Cody explain how an increase in stock value between related parties satisfies the arm's length requirement since two uncontrolled taxpayers would not be able to engage in this transaction because it would require an actual exchange of shares, which did not happen here.

Thus, CarMax East's transfer of the intangibles to CarMax West for zero compensation, and then CarMax West's almost immediate contribution of those same intangibles to CBS in exchange for an enormous ownership interest in CBS facilitated a huge shift in income from CarMax East to CarMax West that appears to be a scheme to minimize CarMax East's taxable income. However, whether the partnership distributions are proper or not does not matter nearly as much as the **effect** of the partnership ownership interests on taxable income. Even if the partnership percentages are correct, I would still find that standard apportionment does not fairly reflect the extent of CarMax East's business activity in this state because the partnership distributions effectively distorted CarMax East's taxable income under standard apportionment.

Management Fee

The Department contends the Management Fee improperly siphoned income from CarMax East to CarMax West. To defend its Management Fee, CarMax presented two transfer pricing studies that E&Y completed in 2012 and 2015.⁴⁰

CarMax's Calculation of the Management Fee

The first year of the audit, CBS utilized the 2012 study and charged a Management Fee of \$1,107 per vehicle.⁴¹ The second two years of the audit, it used the 2015 study and charged \$1,192 per vehicle. CBS invoiced CarMax West and CarMax East for the Management Fee every month, initially based upon a budget perspective. Then, the fee was trued-up to actual sales and costs on a monthly basis.

CarMax calculated the Management Fee based upon nine components, some of which were calculated as a percent of sales and some of which were calculated based upon cost plus

⁴⁰ CarMax has transfer pricing studies completed every three years. Here, the 2012 transfer study was the more in-depth study. Although annual updates are not required, it is common for companies to conduct transfer pricing studies around every three years after an initial planning study is completed because an intercompany transaction is added. How frequently studies are completed depends on whether the business changes and what risks management is willing to undertake. The 482 Regulations reflect this—if intercompany transactions are a major part of a company's business, then they represent a higher risk for issues and thus merit more frequent and thoughtful studies, whereas one relatively minor intercompany transaction may not merit much investment in studies.

⁴¹ In addition to the transfer pricing studies, CarMax also utilized budgeted sales projections and department budgets to estimate the Management Fee on a per vehicle basis for all tax years at issue.

markup. The nine components and the Management Fee, and the rate charged for those components during the audit years, were as follows:

	FY2016 Rate	FY2017 Rate	FY2018 Rate
Value Added Services (% of Sales)			
Advertising and Marketing Services Fee	2.00%	2.00%	2.08%
Intellectual Property License Fee (Trade Names and Intangibles)	0.50%	0.50%	1.50%
Value Added Services (Per Car Range)			
Analytical and Business Development Service Fee	\$413	\$506	\$508
General Support Services (Cost Plus)			
General Management and Administrative Support Services Fee	6.70%	7.90%	7.90%
Human Resources Services Fee	6.70%	7.90%	7.90%
Finance and Accounting Services Fee	6.70%	7.90%	7.90%
Real Estate Services Fee	8.90%	10.40%	10.40%
Legal Services	6.70%	7.90%	7.90%
Management Information Services Fee	6.70%	7.90%	7.90%

See Joint Exhibit 37.

All the fees in this chart were derived from the E&Y transfer pricing studies and represented CarMax's chosen value from an arm's length range. For example, based upon the 2015 study (FY2017), CarMax chose to impose the median of the arm's length range, which was 2%.⁴² Accordingly, it multiplied its projected sales by 2% to arrive at a fee. However, to reach a per vehicle Advertising and Marketing Services Fee, 2% of projected sales was then divided by the FY2017 units to be sold. The per vehicle Advertising and Marketing Services Fee, \$404 in FY2017, was then aggregated with the other calculated per vehicle service fees to arrive at the total Management fee of \$1,192 for FY2017. A breakdown of the Management Fee for FY2017 is provided below:

⁴² If the total per vehicle Management Fee changes very little from one year to the next, then CarMax may adjust one of the rates to keep the per vehicle charge the same for administrative ease for the invoicing department. This is why the percent sales rate for the Advertising and Marketing Services Fee changed from 2.0% to 2.08% from 2017 to 2018. When CarMax adjusts the rate, they do so within the arm's length range of the applicable transfer study.

FY2017			
Transaction	Arm's Length Range	Rate Used	Markup Per Vehicle Sold
1. IP and Business Process Intangibles	0.5% to 1.3% of sales, median of 0.6%	0.50%	\$101
2. Corporate Management	4.4% to 12.5% markup on cost, median of 7.9%	7.90%	\$178
3. Advertising and Marketing	2.0% to 5.0% of sales, median of 2.0%	2.00%	\$404
4. Real Estate	8.0% to 11.9% markup on cost, median of 10.4%	10.40%	\$3
5. Quantitative Analytics	\$491.00 to \$736.50 per vehicle sold	\$506	\$506
Total Management Fee			\$1,192

E&Y Transfer Pricing Studies

The E&Y transfer pricing studies from 2012 and 2015 are substantially similar in their approaches and conclusions.⁴³ The studies divide the Management Fee into five separate intercompany transactions (Transactions 1-5), which were priced separately.⁴⁴ The five individual transfer prices were then combined, by CarMax, into a single Management Fee per car (as demonstrated in the chart above). Transaction 1 isolated the value attributable to CBS licensing the trademarks, tradenames, and business intangibles to CarMax East and CarMax West. Transaction 2 isolated the value of CBS's corporate management services. Transaction 3 isolated the value of CBS's advertising and marketing services. Transaction 4 isolated the value

⁴³ In the experts' analyses of these studies, they focused on the 2015 study, upon which I also center my analysis.

⁴⁴ Dr. DeRamus asserted the studies should have included a sixth transaction representing the value added to CAF financing transactions by the local stores. In his opinion, the stores should have received origination fees for bringing in the customers for the loans, even if CarMax East and CarMax West did not execute the financing. He estimated the origination fee would be about \$314 based upon some documentation he saw from CarMax. Nonetheless, he did not know how this number was calculated, although he considered it a "lower bound" on what would be charged for an origination fee. I conclude there was insufficient evidence to show what amount should have been charged for the origination fee. Additionally, this fee would not have been charged as part of the Management Fee since this fee only incorporates payment from CarMax East and CarMax West to CBS, not the other way around. Nevertheless, I do not find that this transaction, on its own, has any great impact on the outcome of this case. To the extent an origination fee should have been charged, it would shift some income back to CarMax East and CarMax West but not enough to overcome the income-shifting effect of the partnership distributions. Therefore, I gave little weight to Dr. DeRamus's testimony on this subject and thus this evidence was not determinative of the case's outcome.

of CBS's real estate services. Transaction 5 isolated the value of CBS's data analytics and business strategy services (also described as business process intangibles).

Functional Analysis

Before I discuss the five transactions priced by E&Y, it is helpful to first understand the experts' functional analyses of CBS and its relationship to the Group. The experts' functional analyses necessarily guided their opinions on whether E&Y chose the best methods in their studies and whether E&Y's results were reliable.⁴⁵

Dr. Cody determined CarMax East's and CarMax West's primary function was to execute sales in accordance with any processes established by CBS. He further determined CBS had three primary functions: (1) business strategy and the tools and systems associated with it; (2) financing through CAF; and (3) administrative headquarters functions. Dr. Cody further opined that because of the uniqueness of each used car sold by CarMax, economies of scale was not a large value driver in the context of CarMax's purchase of inventory.

Dr. DeRamus disagreed with Dr. Cody's characterization of the role the local stores play as mere executors of CBS's business strategies. In his opinion, the local stores drove value for the business because the local stores bought inventory, reconditioned the cars, sold the cars, and interacted with customers.

Also in contrast to Dr. Cody, Dr. DeRamus ascribed much of CarMax's competitive advantages to its economies of scale. He asserted that because the CarMax Group is a national chain, it was able to provide its customers with a selection of vehicles that most used car dealers could not. Dr. DeRamus further asserted that CarMax's economies of scales gave it (1) an informational advantage for collecting data on what cars to sell and where and when to sell them, and (2) allowed it to spread costs, including its reconditioning costs, over more sales.

I found Dr. Cody too easily dismissed economies of scale as a competitive advantage and value driver. While CarMax is in the business of buying unique items, CarMax still benefits from

⁴⁵ The functional analyses presented by the parties were more akin to overall analyses of CarMax's business and what drives value in the business. However, functional analyses under the 482 Regulations are much more specific to the transaction being evaluated because the goal of the functional analysis is to gauge the similarity of comparable uncontrolled transactions. *See* 26 C.F.R. § 1.482-1(d)(3)(i) ("Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction."). Therefore, while this general understanding of CarMax's functions and value drivers provides context, each discrete transaction requires its own functional analysis to determine whether sufficiently similar comparables exist to benchmark a particular transaction using a particular method under the 482 Regulations. *See id.*

its large size in several ways, including the selection it offers to customers and its ability to spread costs. However, I also find that Dr. DeRamus minimized the impact of CBS's strategic involvement when he determined the local stores created almost all value for the business. While it is true that the actual sale of the car, the largest value generator, happens at the local store, many strategic decisions underlay that sale—the price CarMax pays for its cars at auction or in the appraisal lane; the decision about what to recondition; the price at which to sell the car—were influenced, if not governed, by CBS's systems and processes.⁴⁶ Indeed, while the sales themselves created profit, the systems increased the margin of that profit.

Overall, I find the local stores, through the actual sales of cars and the employees' input as to the condition of the cars purchased, created the most revenue for CarMax. Nonetheless, I recognize that CarMax's gross profit margins were enhanced by CBS's proprietary systems. CBS's systems assisted local stores in making decisions about how to price cars, what cars to buy and how much to pay for the cars, and when and how to recondition cars. Still, I was unconvinced that these systems create more value than the employees and the local stores themselves who actually make and execute the decisions leading to sales. Moreover, CarMax benefitted from economies of scale. Its size and nationwide presence made it a formidable competitor in an otherwise fractured used car market with mostly smaller, independent sellers. I further find that CarMax's reputation for quality, low-mileage used cars, its national selection, no-haggle pricing, customer-friendly service, and financing availability also drove value for the company. With this analysis in mind, I turn to the transactions at issue.

Transaction 1

Transaction 1 priced the value of CBS's IP and its business process intangibles that were established systems.⁴⁷ E&Y selected the comparable uncontrolled transaction (CUT) method to price this transaction, which is one of the methods specified for the pricing of intangibles under

⁴⁶ Dr. DeRamus acknowledged that savings in the reconditioning process add up to "significant dollars" but attributed the value generation to the local stores performing the reconditioning rather than CBS's process for when and how to recondition.

⁴⁷ E&Y separated the business process intangibles into two kinds: systems and strategies. Some business process intangibles were also defined as both a system and a strategy. Only the business process intangibles that were "systems" were valued in Transaction 1. How this distinction was made and how the two kinds of intangibles were valued will be explained further under Transaction 5. However, the reason for the distinction was never sufficiently explained. In Dr. DeRamus's opinion, all the business process intangibles should have been valued together. Indeed, separating the intangibles into two kinds only seems to add confusion and decrease the reliability of E&Y's results because valuing the distinction relied upon educated estimations rather than concrete numbers.

the 482 Regulations. 26 C.F.R. § 1.482-4(c). Ironically, E&Y rejected this method in its 2004 Valuation Study when it valued the company's IP and business process intangibles. In that study, E&Y rejected CUT because it determined there were no companies with sufficiently similar comparable intangibles due to CarMax's unique combination of intangibles.

The CUT method "evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction." *Id.* The 482 Regulations describe its application as follows:

If an uncontrolled transaction involves the transfer of the **same intangible** under the **same, or substantially the same, circumstances** as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Circumstances between the controlled and uncontrolled transactions will be **considered substantially the same if there are at most only minor differences** that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of **comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.**

26 C.F.R. § 1.482-4(c)(2)(ii) (emphasis added). Thus, the CUT method generally requires a very high degree of comparability to be reliable.

To determine the comparability of a controlled and uncontrolled transaction, the analyst should assess the specific factors listed in § 1.482-1(d): functions; contractual terms; risks; economic conditions; and property or services. 26 C.F.R. § 1.482-4(c)(2)(iii)(A). Additionally, a comparability analysis under CUT must also consider whether the uncontrolled transaction is "used in connection with similar products or processes within the same general industry or market" and "have similar profit potential." § 1.482-4(c)(2)(iii)(B)(1).

Furthermore, "[i]n evaluating the comparability of the circumstances of the controlled and uncontrolled transactions the following factors "may be particularly relevant": (1) the terms of the transfer; (2) the stage of development of the intangible; (3) rights to receive updates, revisions, or modifications of the intangible; (4) the uniqueness of the property; (5) the duration of the license; (6) any economic and product liability risks; (7) the existence and extent of any collateral transactions or ongoing business relationships; (8) the functions to be performed by the transferor and transferee; and (9) the accuracy of the data and the reliability of assumptions used. § 1.482-4(c)(2)(iii)(B)(2).

E&Y determined the CUT method was the best method because it found uncontrolled transactions it deemed sufficiently comparable to support this method. The uncontrolled transactions it utilized were the licensing components of franchise agreements from the retail industry. E&Y chose franchise agreements from within the automotive industry (new car dealers, used car dealers, automotive parts dealers, tire dealers). They then narrowed their search further by eliminating franchise agreements that dealt with lump sum transfers for IP, agreements that were not licensing agreements, or agreements pertaining to an unlike industry. In total, they identified eleven acceptable franchise agreements. These agreements primarily came from oil change companies and tire service companies; none were car dealers.

The franchise agreements selected by E&Y included some bundled valuables that were not present in Transaction 1, including general corporate support and assistance with real estate. To avoid including compensation for the corporate support services in their valuation, E&Y quantified the value of the additional services and subtracted them from the franchise fees so that the only part of the franchise agreements being valued were the trademarks, tradenames, and business process intangibles. To quantify and exclude the corporate support services, E&Y looked at a specific type of franchise relationship to isolate the price of the intangibles in the franchise agreements—the relationship between a master franchisor, a master franchisee, and a franchisee. The proportion of the total royalty rate paid by the franchisee that was remitted to the master franchisor by the master franchisee was utilized to determine the royalty rates that master franchisees would remit to the master franchisor for trademarks, trade names, and business process intangibles. Based upon this analysis, E&Y then concluded, in 2015, the arm's length range for the Transaction 1 was 0.5% to 1.3% with a median of 0.60%.

The experts disagreed about whether E&Y's methodology was the best method and reliable. In Dr. Cody's opinion, E&Y conducted a thorough and diligent analysis of Transaction 1 and he agreed with their selection of CUT as the best method. Additionally, he found E&Y's use of franchise agreements and the adjustments they made to those comparables were reasonable, and their process comported with how he has developed transfer pricing studies in retail over the past twenty years.

In contrast, Dr. DeRamus found E&Y's handling of Transaction 1 was unreliable. He criticized E&Y's selection of the CUT method, which, according to his understanding, should only be used when very similar uncontrolled transactions that do not need to be adjusted to

account for a variable. Dr. DeRamus explained that franchise agreements are very different from trademark license agreements, and E&Y should have used “actual royalty agreements for the use of the trademark.” He further explained that “you rarely find observations, reliable observations of trademarks licenses” in the retail setting because the value in most scenarios is close to zero. He also criticized E&Y for bundling some of the business process intangibles into Transaction 1 instead of simply accounting for all the business process intangibles in Transaction 5.

I find Dr. DeRamus’s criticism of E&Y’s choice of the CUT method is supported by the 482 Regulations. As the 482 Regulations instruct, the CUT method is appropriate where there are comparables involving “the **same intangible under the same, or substantially the same, circumstances** as the controlled transaction.” 26 C.F.R. § 1.482-4(c)(2)(ii). CBS was compensated under a licensing agreement, not a franchise agreement. Additionally, the franchise agreements utilized by E&Y compensated the franchisor for a broader set of intangibles than the licensing fee compensates CBS for. Generally, CUT requires a very rigorous evaluation of the comparability of the controlled and uncontrolled transactions, which was not present here.⁴⁸ See § 1.482-1(d); § 1.482-4(c)(2)(iii)(B)(1); § 1.482-4(c)(2)(iii)(B)(2).

Moreover, the industry from which these franchise agreements originated was a very limited sub-part of the broader automotive services industry—namely, oil change servicers, tires servicers, and a couple franchise agreements for motorcycle dealers. The intangibles at issue in this case deal with the sale of used cars and some ancillary automotive services. Thus, the intangibles at issue are not the same, the industry is not the same, and the circumstances of the transaction are not the same. See § 1.482-4(c)(2)(ii). Indeed, E&Y’s application of CUT is undermined by its own determination that this method was not the best method for an almost identical set of intangibles when it conducted its 2004 Valuation Study. It rejected CUT then for lack of sufficient comparables.

Further, the degree of dissimilarity between CBS’s licensing agreement and the franchise agreements E&Y used is large enough that I do not find E&Y’s attempt to account for the dissimilarity to comport with the 482 Regulations’ allowance for “only minor differences that

⁴⁸ E&Y’s analysis fails under the general guidelines for applying CUT without further evaluation of comparability under the 482 Regulations, including whether the comparable companies selected by E&Y had similar functions, contractual terms, risks, economic conditions, and property and services. 26 C.F.R. § 1.482-1(d)(1). Moreover, E&Y did not include an analysis of how the companies used these franchise agreements “in connection with similar products or processes within the same general industry or market” and “have similar profit potential.” § 1.482-4(c)(2)(iii)(B).

have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made.” § 1.482-4(c)(2)(ii); *see also, e.g., Medtronic, Inc. & Consol. Subsidiaries v. Comm’r of Internal Revenue*, 124 T.C.M. (CCH) 69 (T.C. 2022) (observing that too many adjustments can result in CUT not being the best method). These were not minor differences; E&Y had to go through a fairly extensive process to isolate the value of the intangibles in the franchise agreements using a further level of comparison with master franchisor agreements. *See* § 1.482-4(c)(2)(ii). The reliability of their results was, thus, significantly reduced. *See* 26 C.F.R. § 1.482-4(c)(ii) (“[U]ncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.”).⁴⁹

Based upon the above, I find CUT was not the best method and is not reliable. 26 C.F.R. § 1.482-1(c). Since E&Y’s calculation of the transfer price for Transaction 1 is unreliable, I find that CarMax’s adoption of a transfer price for Transaction 1 that falls within E&Y’s calculated range is also unreliable.

Transaction 2

Transaction 2 valued the back-office corporate support services CBS provided to CarMax East and CarMax West. These are ordinarily considered less valuable services. To benchmark this transaction, E&Y used the comparable profits method (CPM). The CPM “evaluates whether the amount charged in a controlled transaction is arm’s length based on objective measures of profitability (profit level indicators or “PLI”) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.” 26 C.F.R. § 1.482-5. E&Y chose operating profits as a percent of total cost as the PLI. E&Y calculated an arm’s length range of between 4.4% to 12.5% markup on total costs with a median of 7.9%.

According to Dr. Cody, E&Y selected a standard set of comparables for this type of transaction, and the calculated arm’s length range was consistent with Dr. Cody’s expectations.

⁴⁹ Based upon the Record, and to this Court’s knowledge, E&Y did not include copies of the franchise agreements with their analysis or provide a functional analysis or a comparability analysis to justify use of their eleven chosen agreements as sufficiently comparable under the 482 Regulations’ comparability standards. *See* § 1.482-1(d); § 1.482-4(c)(2)(ii). Dr. DeRamus found the failure to include the underlying franchise agreements to be a “major deficiency.” Indeed, without the underlying agreements, which were not supplied by any party, it is impossible for this Court to vet E&Y’s analysis under the 482 Regulations to the degree required had the franchise agreements been appropriate to begin with. However, because I find the comparison of this transaction to franchise agreements is inappropriate under the CUT method, I do not need to venture into that deep of an analysis.

DeRamus agreed with the use of CPM method and its outcome, even if he quibbled slightly with the comparables.⁵⁰

I conclude the E&Y transfer price for Transaction 2 was reasonable and reliable. CPM is commonly used to price the services covered by this transaction and both experts agreed the method, comparables, and results were reasonable.

Transaction 3

Transaction 3 valued the advertising and marketing services. E&Y chose the comparable uncontrolled services price method (CUSP). CUSP is identical to the CUT method except that it is adapted for services. CUSP “evaluates whether the amount charged in a controlled services transaction is arm’s length by reference to the amount charged in a comparable uncontrolled services transaction.” 26 C.F.R. § 1.482-9(c) (Westlaw through 89 F.R. 51276). Like CUT, CUSP requires a high degree of similarity between the controlled and uncontrolled transactions to be reliable. With regard to comparability, the 482 Regulations provide that not only must the functions, contractual terms, risks, economic conditions, and property or services of the transactions be considered, but similarity of the services rendered and of the intangible property used in performing the services (if any) is very important. § 1.482-9(c)(2)(iii). Moreover,

⁵⁰ Although Dr. DeRamus agreed CPM was a reasonable method for this transaction, because the ownership interests in CBS are not arm’s length, he noted that CPM would not produce an arm’s length result. To correct the effect of the partnership distributions, Dr. DeRamus suggested the service cost method (SCM) should be applied to Transaction 2. Under the SCM, the transfer price is essentially equal to cost with no markup (profits are eliminated). *See* 26 C.F.R. § 1.482-9(b) (“The services cost method evaluates whether the amount charged for certain services is arm’s length by reference to the total services costs (as defined in paragraph (j) of this section) with no markup.”). By eliminating profits in this case, SCM would prevent CBS from receiving profit that would then be redistributed through the partnership, thus limiting the effect of the partnership distributions on CarMax East’s and CarMax West’s taxable income. Indeed, Dr. DeRamus suggested the SCM should be used for all the Management Fee transactions to reduce the Management Fee to cost. I find Dr. DeRamus’s opinion to be problematic.

First, whether the partnership distributions are correct is an important issue in this case that can, and should, be dealt with separately from the discrete transactions priced in the Management Fee, which may very well be arm’s length themselves. Dr. DeRamus was essentially suggesting that the Management Fee be adjusted to correct a distortion in the partnership distributions. Yet, Dr. DeRamus provided no authority under the 482 Regulations for applying them in this way.

Second, the SCM is elected by the taxpayer and cannot be imposed by the IRS or the Department in this case. Moreover, the SCM may only be elected under very specific circumstances, and most of the Management Fee transactions would not qualify for its use. *See* 26 C.F.R. § 1.482-9(b)(2)(i)-(iv) (describing the qualifying circumstances). E&Y’s 2015 study specifically rejects SCM because CarMax elected a markup on total costs for the services provided under Transaction 2.

Therefore, I reject Dr. DeRamus’s assertion that SCM should be used for this transaction, or any other transaction within the Management Fee, to achieve a more arm’s length result in light of, and correcting for, the partnership distributions.

because **even minor differences** in contractual terms or economic conditions **could materially affect the amount charged** in an uncontrolled transaction, **comparability under this method depends on close similarity** with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled services price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction **if an uncontrolled transaction has no differences from the controlled transaction that would affect the price**, or if there are only **minor differences** that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, **if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.**

26 C.F.R. § 1.482-9(c)(2)(ii) (emphasis added).

According to the 2015 Transfer Pricing Study, E&Y chose CUSP over CPM because the advertising fees in the franchise agreements it selected for Transaction 1 were sufficiently similar to be more reliable than finding comparables for the CPM. Specifically, E&Y could not “identify any parties providing services to CarMax Stores similar to the services being provided by [CBS].” Thus, for comparables, E&Y returned to the franchise agreements it selected for Transaction 1 and identified eight agreements that contained separate compensation for advertising services similar to those provided by CBS. Based upon these comparables, E&Y determined the arm's length range for advertising fees as a percentage of sales was between 2.0% and 5.0% with a median of 2.0%.

Dr. Cody found E&Y's choice of the CUSP method and their use of franchise agreements to be reasonable and appropriate based upon his experience. He explained it is common for a retailer to have a centralized advertising and marketing component that incurs expenses, which are then reimbursed by the individual retail operations that benefit.⁵¹ The local store may conduct

⁵¹ There was evidence, according to Dr. DeRamus, that CarMax East and CarMax West were expending a substantial amount of the advertising costs in the first instance and were reimbursed by CBS, which then allocated the costs to itself. Specifically, based upon CarMax's accounting records, Dr. DeRamus calculated CarMax East had a total of \$96,558,867 in advertising expenses, CarMax West had \$41,485,393 in advertising expenses, and CBS had \$20,508,087 in advertising expenses in the first instance. Thereafter, CBS picked up the advertising expenses for the Group such that it incurred \$132,806,425 in expenses. Whether the costs initially incurred by CarMax East and CarMax West reflected their own development of advertising and strategies, or simply reflected the costs of implementing strategies and campaigns developed by CBS, was unclear. However, the evidence generally showed that CBS developed most of the advertising and marketing for the local stores.

some of its own advertising while also benefiting from the national website or national commercials that bring customers into the local store.

Dr. Cody further explained that franchises typically charge an advertising fee for the value of their advertising services. And, because CarMax's business is set up parallel to a franchise, Dr. Cody thought using the franchise agreement comparables from Transaction 1 was appropriate. Additionally, Dr. Cody asserted the fee is usually expressed at a percent of revenue of the retailer, which is what E&Y did for CarMax. Dr. Cody also found CarMax's decision to impose a 2% fee aligned with industry comparables.

Dr. DeRamus disagreed with E&Y's choice of CUSP, which he found to be inconsistent with the 482 Regulations and unreliable. Dr. DeRamus explained the CUSP method requires "very, very close comparability," if not identical, and E&Y used advertising fees for franchises, which CarMax is not. He also criticized E&Y and CarMax, again, for not providing a copy of the franchise agreements underlying the studies.

With regards to the outcome of E&Y's application of CUSP, Dr. DeRamus found that it was "on its face patently unreasonable" because CBS was charging a 2% fee for something that cost 1% to provide. He calculated the 2% advertising fee to equate to a markup on total costs of 113.1% to 115.5% over the audit years.

Instead of CUSP, Dr. DeRamus would have applied the CPM. When he used CPM to benchmark advertising services companies, he concluded the arm's length range for a markup on total costs was 4.4% to 8.9% over the audit years with an average of 8.3%.

Similar to my findings in Transaction 1, I conclude that CUSP was not the best method for this transaction and is unreliable pursuant to the 482 Regulations. Indeed, CUSP requires a high degree of comparability. Like in Transaction 1, I conclude that advertising under a franchise agreement is not sufficiently similar to CBS's provision of advertising services. CarMax is not a franchise, even if it may be similar in some ways. Neither E&Y's study nor Dr. Cody explained to a sufficient degree of detail how CBS and a franchise are comparable in their functions, contractual terms, risks, economic conditions, and property or services of the transactions. § 1.482-9(c)(2)(iii). As the 482 Regulations discuss, "even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences." § 1.482-9(c)(2)(iii). Without the

underlying franchise agreements available for review, differences in contractual terms or economic conditions cannot be ascertained, and the similarity of these franchise agreements cannot be shown or vetted.

Transaction 4

Transaction 4 valued the real estate services provided by CBS to CarMax East and CarMax West. The services performed by CBS included site selection, property acquisition and negotiations, negotiations of leases, market research around site selection, and other ancillary services. E&Y used CPM to benchmark the price for this service based on the markup on total costs (MTC). In their 2015 study, E&Y found comparable companies that performed real estate services and determined the arm's length range was 8.0% to 11.9% with a median of 10.4%.

Dr. Cody explained that, like the back-office services in Transaction 2, the real estate services provided in Transaction 4 are very straight-forward and common. He determined E&Y's method and results were reasonable and reliable. Similarly, Dr. DeRamus determined E&Y selected the best method for this transaction, and, similar to Transaction 2, while he would quibble with some of the specific comparables, they "appeared to be broadly reasonable."

I find CPM was a reasonable and reliable method for this transaction. I further find that CarMax's transfer price for this transaction, which was based upon E&Y's study, is reasonable and reliable.

Transaction 5

Transaction 5 valued the analytical and business development services (quantitative analytics), including the related business process intangibles. To benchmark this function, E&Y used an unspecified method (UM)⁵² because "transaction based comparables were not available and a traditional cost-base analysis would not reflect the value being driven for CarMax Stores through the analytical and business developments services." In its 2015 transfer pricing study, E&Y found:

The analytical and business development services provided by [CBS] are proprietary and directly relate to CarMax Stores competitive position in the market place. The services are primarily provided by [CBS]'s Quantitative and Analytics group. Because of the unique and proprietary nature of these services,

⁵² Unspecified methods are recognized methods under the 482 Regulations. *See, e.g.*, § 1.482-9(h).

transaction-based comparables were not available and a cost based approach was not deemed to be appropriate.

Thus, [CBS] determined the value being delivered through these services. The value being delivered can be traced through either cost savings or revenue generation. Appendix 8 summarizes the cost savings and revenue generated for the various business strategies and systems developed by this group. The total value calculates to \$1,526.50 per vehicle.

Thus, the data used to calculate the transfer price for Transaction 5 came directly from CarMax and CBS. Appendix 8 to E&Y's 2015 study contains a list of cost savings or revenue-generating systems and strategies or "both" (the item was both a system and a strategy). Each system/strategy was assigned a value per car in Appendix 8 that was generated from CarMax's internal data.

According to Dr. Cody, systems are tools that have already been rolled out and are in place—these systems equate to the business process intangibles from Transaction 1. Strategies, in contrast, are newer systems that are currently in development or decisions about how to use tools operationally that will have an effect on CarMax's overall business strategy and competitiveness. Dr. Cody stated the decision tree CBS developed regarding when and how to paint a car was a system, and how to take advantage of the additional margin created by the system was a strategy. He also explained systems and strategies can overlap. In Transaction 5, E&Y was attempting to value the strategies. The systems, in contrast, were purportedly valued in Transaction 1.

E&Y determined there was overlap between the value of the "systems" (aka business process intangibles) that were lumped into Transaction 1 and the strategies being valued in Transaction 5. To avoid double-counting, E&Y eliminated the systems-related value that was already priced in Transaction 1, which it estimated to be \$299 based upon the values assigned to these systems in Appendix 8. However, some analytical and business development services involved both systems and strategies that were difficult to parse. Based upon CarMax's estimation that at least 40% and upwards of 60% of its analytical and business development services were systems-driven, E&Y developed a range of value for the remaining business strategies. In 2015, it calculated that between \$491 and \$736.50 per vehicle was attributable to strategies. CarMax chose to impose a \$413, \$506, and \$508 fee per car for Transaction 5 in each audit year, respectively.

In reviewing this transaction, Dr. Cody emphasized the importance of applying a higher level of scrutiny to a transfer price, like this one, that relies exclusively on internal company data with no reference to uncontrolled companies or uncontrolled transactions. In particular, he stressed the need to investigate why the internal data was collected, the circumstances under which it was collected, etc., and these factors all contribute to the data's reliability. Dr. Cody specifically found the CarMax's internal data to be reliable because it was not based upon forecasting, but rather based upon actual tests with proven results—the data went “right to the actual value created by the analytical and business strategy tools that CBS develops and then implements.” Overall, Dr. Cody found E&Y's analysis was reasonable and it comported with his own investigation and analysis of the business analytics' group contributions.

In contrast, Dr. DeRamus found E&Y's application of the UM to be inconsistent with the 482 Regulations because their study did not provide all the data and assumptions underlying the application of the method beyond the figures in Appendix 8. Accordingly, he found their application of this method “not clear at all.” Similarly, he criticized the values CarMax and E&Y assigned to Transaction 5—the \$1,526 per car for all systems and strategies and the number they derived for the excluded systems—\$299—as having no discernable basis that he could recalculate and check. According to Dr. DeRamus, the \$1,526 number “just screams out as being unreliable.” Dr. DeRamus also asserted that CarMax makes about \$2,156 in gross profit off each car and \$1,526 represents about 70% of that, which Dr. DeRamus found to be absurd on its face for such a small group within the company.

According to Dr. DeRamus, this function was much less valuable than E&Y calculated because selling cars, generally, is what produced profit for the company, and any profit generated by CBS through strategies was much less significant. Dr. DeRamus criticized E&Y's assignment of such a large value to what are, in his opinion, ubiquitous pricing and inventory algorithms that are common functions across large companies and based upon standard technology and use standard methods. In other words, Dr. DeRamus implied that these algorithms are so standard and common that the value is only as good as the data inputs.⁵³

⁵³ Although I generally find Dr. DeRamus's opinion more persuasive, I disagree with his complete minimization of the value and impact of CBS's analytical and business development services. The local stores are responsible for the sale of the car which is the main profit driver; nevertheless, strategies to improve margins and reduce costs are an important profit driver, along with the benefits of economies of scale. Moreover, while data systems may be ubiquitous across an industry, they can still have value when the systems are tailored to the company and do a uniquely good job for the company.

Dr. DeRamus further compared the estimated cost of providing the business and analytics services to the profits earned by this function. Based upon his estimation of CBS's costs, mostly payroll, he estimated the markup on total costs of to be on the order of 4,000% to 5,000%. Dr. DeRamus emphasized that whether the markup up was 1,000% or 5,000%, he could not be sure without more detailed, granular information, but his estimation was sufficient to show that the charge was not arm's length.⁵⁴

Overall, it is difficult to analyze whether the E&Y transfer price is reliable or, rather, sufficiently reliable to fall within an arm's length range. The 482 Regulations provide the following guidance for using the unspecified method for a services transaction:

[I]n establishing whether a controlled services transaction achieved an arm's length result, **an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction** (for example, outsourcing a particular service function, rather than performing the function itself). As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482-1(c). Therefore, in accordance with § 1.482-1(d) (comparability), **to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced**. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

26 C.F.R. § 1.482-9(h) (emphasis added).

In theory, as Dr. Cody noted, CarMax's data development regarding its cost-savings and increased margins is sound. CarMax described a very rigorous, on-going testing process that is undertaken independent of any need for transfer pricing data. Therefore, E&Y did not use forecasted data, which both Dr. Cody and the 482 Regulations describe as less reliable. However, the use of rigorously collected, non-forecasted data makes it all the more disappointing that

⁵⁴ Dr. DeRamus also opined that if CarMax's data analytics group created so much value, CarMax would presumably sell its highly profitable data analytics to other companies and its competitors. On the one hand, this makes sense—be in the business that will make you the most money. However, CarMax said it treats its business process intangibles like a trade secret, and I do not find it unreasonable that CarMax would not wish to sell a major source of its success in its industry. Thus, I did not find this argument persuasive.

Similarly, based upon how much value was attributed to the data analytics group, Dr. DeRamus opined that he believed a passive association benefit from CarMax's economies of scale was being lumped into Transaction 5 to add more value when no specific entity within the CarMax Group should get to claim the value of passive association benefits, which is improper in transfer pricing. However, I find no evidence that CarMax added a value for a passive association benefit into its calculation of Transaction 5.

E&Y's study simply takes CarMax at its word without including the underlying data calculations for the figures listed in Appendix 8. The figures in Appendix 8 are clearly summary totals of other calculations, and, while CarMax submitted a spreadsheet with a summary tab (Joint Exhibit 68) that further explains these figures, the explanation is insufficient to explain the genesis of these figures.

Based upon the 482 Regulations, Dr. DeRamus's critique concerning the underlying data is valid. Using internal data that is not sourced from uncontrolled transactions is subject to higher scrutiny under the 482 Regulations. *See* 26 C.F.R. § 1.482-9(h). Here, there is no way to scrutinize the data in Appendix 8 because the underlying calculations are not available. For example, CarMax conducted testing related to its reconditioning process, and determined the decision tree they developed for determining whether to paint a car saved them approximately \$150 per vehicle. In Appendix 8, a figure of \$450 is listed for "Waste elimination – recon," which appears to be shorthand for reconditioning. It is unclear what makes up this figure—presumably, \$150 of that figure is the repainting system. However, because the only data we have to evaluate is Appendix 8, it is impossible to know what other cost-savings make up this figure and how those cost-savings were calculated.

Moreover, as noted by Dr. DeRamus, it is difficult to imagine that these systems and services developed by the business analytics team are responsible for about 70% of the profits CarMax makes on each car. It is even more unlikely that even if the value of these services is not tied to cost, the percent markup on cost would be in the thousands as estimated by Dr. DeRamus. Nevertheless, I disagree with Dr. DeRamus's assessment that the data analytics services provided by CBS have little to no value above cost. I thus did not find the entirety of Dr. DeRamus's functional analysis to be reliable or credible based upon his lack of understanding of CBS's data analytics functions.

Additionally, Dr. Cody explained that the value of this kind of transaction is not tied to cost in the way that some others are. In Dr. Cody's opinion, the value of the business analytics group is not related to the cost incurred for those activities because the value of the systems being developed continues long after the effort it took to develop and test them stops. Thus, the initial expense to develop the system is not indicative of its value of the course of its lifetime, especially when, as here, CBS continues to modify, improve, and increase the efficacy of those systems to produce more value over time.

Overall, I conclude that E&Y's use of an UM with internal data that is not capable of being scrutinized renders this method unreliable under the 482 Regulations. *See* 26 C.F.R. §1.482-1(c)(2)(ii) (indicating that an analysis is relatively more reliable as the completeness and accuracy of data increases). Additionally, there was no data or quantitative evidence to support CarMax's estimation that 40% to 60% of the value of its combined systems and strategies represent the systems-driven value. Nevertheless, I find the business analytics group provides a service of some value to CarMax that is worth more than a modest markup. What the arm's length price for this function should be was not established by either party.⁵⁵

Overall Reliability of the Management Fee

I conclude the evidence shows the Management Fee, as a whole, is not reliable. As I have discussed, E&Y's methodologies for Transactions 1, 3, and 5 are not reliable. These are the largest value-earning transactions; accordingly, their unreliability has a significant impact on the overall reliability of the Management Fee. Therefore, I conclude the E&Y study transfer pricing studies from 2012 and 2015 do not reliably support the price of the Management Fee. In turn, they do not justify the amount of income being shifted from CarMax East and CarMax West to CBS for its services through the Management Fee.

Further, neither expert provided a reliable, arm's length transfer price for the Management Fee under the 482 Regulations. Without reliable transfer prices for Transactions 1, 3, and 5, it is hard to establish the extent to which the Management Fee may be improperly siphoning income away from CarMax East as the Department asserts.

If this were an ordinary transfer pricing case, the Court would be in a difficult position to try and calculate the correct transfer prices. *See, e.g., Sundstrand Corp. & Subsidiaries v. Comm'r*, 96 T.C. 226, 354 (1991) ("Should petitioner overcome [the Commissioner's] presumption of correctness and prove that the deficiencies set forth in the notice of deficiency are arbitrary, capricious, or unreasonable, but fail to prove that alternative allocations it proposes satisfy the arm's-length standard, the Court must determine from the record the proper allocation of income[.]"). However, while Petitioner has used transfer pricing studies to defend the transfer of income between related parties in this case, the Department has asserted that standard

⁵⁵ Because I find that Dr. DeRamus had an insufficient understanding of the business analytics group at CBS, I do not find Dr. DeRamus's alternative application of the CPM to Transaction 5 to be reasonable or reliable.

allocation and apportionment does not fairly reflect CarMax's taxable income in South Carolina. Therefore, standard allocation and apportionment is the lens through which I view the unreliability of the Management Fee. Moreover, whether the Management Fee is acting as an improper siphon or not, its income-shifting effect is not nearly as significant as that of the partnership distributions. Indeed, even if the Management Fee is an arm's length price, because of how the partnership distributions are set up, a substantial amount of CarMax East's income will still be shifted to CarMax West.⁵⁶

Tax Policy Considerations

Professor Richard Pomp testified on behalf of Petitioner. He is currently the Alva P. Loisel Professor of Law at the University of Connecticut and the Board of Trustees Distinguished Professor. The Court qualified Professor Pomp as an expert in tax policy. Professor Pomp explained that states imposing corporate income taxes generally select one of two different reporting methods, which they require taxpayers to use: (1) separate reporting, or (2) CUR.

According to Professor Pomp, economic development reasons might influence a state to choose separate reporting over CUR. He explained that southern states, which historically had more agriculture-based economies, began using separate reporting to compete with northern states, which had more industrial-based economies and thus had more infrastructure that would be attractive to businesses. Separate reporting can be more attractive to businesses, especially when combined with a single sales factor, because it creates an advantageous tax climate, particularly for companies looking to invest property and payroll in a particular state while selling in other states.

On the other hand, a state might choose to require CUR to address tax minimization strategies. Professor Pomp explained that CUR, if done on a worldwide basis, would undercut tax havens in other countries. Professor Pomp has been a long-standing proponent of CUR, and if this were a legislative hearing, he would recommend that South Carolina adopt CUR.

Professor Pomp also discussed alternative apportionment statutes, Section 18 of UDITPA, and how good tax policy would suggest using these statutes. He explained that alternative apportionment statutes function like a safety valve for unusual circumstances where

⁵⁶ To the extent the Management Fee was too high, the income shifting effect of the partnership distributions was exacerbated.

the standard apportionment method is not working for the particular facts of a taxpayer's business. He believes this is good tax policy because a relief mechanism, like South Carolina's alternative apportionment statute, should not be interpreted so broadly that it swallows up the standard method. Instead, alternative apportionment should be used judiciously such that the default method is predominantly used, and taxpayers' reliance interests are protected.

Finally, Professor Pomp opined that when the alleged tax defect is with a transfer price rather than the apportionment method, the appropriate remedy is to alter the transfer price, not change the taxpayer's reporting method. In his opinion, changing a taxpayer's reporting method in this situation is unwarranted and inconsistent with the purpose of alternative apportionment.

ISSUES

1. Does the Department have authority under subsection 12-6-2320(A)(4) to require CarMax East to use CUR?
2. Does standard allocation and apportionment fairly represent the extent of CarMax East's business activity in South Carolina?
3. Is the application of CUR reasonable and equitable?

CONCLUSIONS OF LAW

Standard of Review

This Court has jurisdiction over this case pursuant to section 12-60-460 of the South Carolina Code (2014) and section 1-23-600 of the South Carolina Code (Supp. 2023).

This is a contested case that is heard *de novo*. *Brown v. S.C. Dep't of Health & Env't Control*, 348 S.C. 507, 512, 560 S.E.2d 410, 413 (2002) (explaining that a contested case before the ALC is "in the nature of a de novo hearing with the presentation of evidence and testimony"). The standard of review is a preponderance of the evidence. S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2023); *see also Anonymous (M-156-90) v. State Bd. of Med. Exam'rs*, 329 S.C. 371, 375-78, 496 S.E.2d 17, 19-20 (1998) ("Absent an allegation of fraud or a statu[t]e or a court rule requiring a higher standard, the standard of proof in administrative hearings is generally a preponderance of the evidence."). Generally, the party asserting the affirmative issue has the burden of proof. *DIRECTV, Inc. & Subsidiaries v. S.C. Dep't of Revenue*, 421 S.C. 59, 78, 804 S.E.2d 633, 643 (Ct. App. 2017). However, when the Department asserts an alternative apportionment method under section 12-6-2320 of the South Carolina Code, the Department has the burden of proof. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C.

79, 89, 767 S.E.2d 195, 200 (2014); *Rent-A-Ctr. W. Inc. v. S.C. Dep't of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016).

The Unitary Business Principle and Combined Reporting

It is undisputed that Petitioner CarMax East is part of a unitary business. Its status as a unitary business allowed the Department to require CUR in this case. Therefore, before I discuss the applicable tax law in this case, a brief overview of the development of combined reporting in the context of unitary businesses is helpful.

As early as the 1920s, tax authorities and courts wrestled with how to deal with multistate corporations whose businesses were so interconnected and “unitary” in nature that it was difficult to determine where value was being generated for the purpose of tax apportionment. *See Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff & Gretton v. State Tax Comm’n*, 266 U.S. 271 (1924); *Hans Rees’ Sons v. State of N. Carolina ex rel. Maxwell*, 283 U.S. 123 (1931). “Because of the complications and uncertainties in allocating the income of multistate businesses to the several States,” the “unitary business principle” was developed, which permitted “[s]tates to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State.” *Allied-Signal, Inc. v. Dir., Div. of Tax’n*, 504 U.S. 768, 778 (1992). In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983) (*Container Corp.*), the U.S. Supreme Court described the “unitary business/formula apportionment method.”

The unitary business/formula apportionment . . . rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the “unitary business” of which the taxed enterprise’s activities in the taxing jurisdiction form one part, and then apportioning the total income of that “unitary business” between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation’s activities within and without the jurisdiction. This Court long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints.

Container Corp., 463 U.S. at 165.

“The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting.” *Allied-Signal, Inc.*, 504 U.S. at 783 (internal quotation marks omitted). Importantly, the unitary business principle only applies to unitary businesses, the hallmarks of which are

generally functional integration, centralized management, and economies of scale. *MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep't of Rev.*, 553 U.S. 16, 30 (2008).

With the development of the unitary business principle, states began to utilize a version of formulary apportionment known as combined reporting, or, as it has been referred to in this case, combined unitary reporting (CUR). The Supreme Court of Illinois aptly summarized the reasoning behind “combined reporting”:

When a unitary business is carried on by an associated group of corporate entities, commonly referred to as a “unitary business group,” resort to formula apportionment is also in order; a group of assets is used by the same overall entity for the generation of income through operation of a single, unitary business. If corporate forms were respected, State income taxation would be as artificially limited and open to manipulation as is the method of separate accounting. To prevent the triumph of corporate formality over economic substance, “combined reporting” is a necessary tool. . . . Combined reporting works to expand application of the unitary-business concept so that an associated group of corporations can be treated as though it constituted a single taxpayer carrying on a unitary business. The total income of a unitary business as carried on by the associated group is determined by combining the income of each corporation involved in that business, and an apportioning ratio is then applied to that total for determination of the taxable income of the corporate member operating in the taxing State.

Citizens Utilities Co. of Illinois v. Dep't of Revenue, 111 Ill. 2d 32, 40, 488 N.E.2d 984, 987 (1986).

Additionally, to address the complexities surrounding apportionment, a subset of states adopted the Uniform Division of Income for Tax Purposes Act (UDIPTA).⁵⁷ UDIPTA Section 18 allows for alternative methods of allocation and apportionment. Although not specifically adopted by South Carolina, UDIPTA Section 18 is practically identical to South Carolina’s “alternative apportionment statute,” subsection 12-6-2320(A)(4). Section 18 states:

If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer’s business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:

⁵⁷ The National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDIPTA) in 1957 to promote conformity among states and their income tax reporting structures. James S. Helms & Geoffrey J. Christian, *The Evolution of UDIPTA Section 18’s Applicability and its Distortion Standard*, 38 J. Corp. Tax’n 3, 3, 2011 WL 2050897, 1.

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

UDIPTA § 18 (Westlaw Edge through 2021 Annual Meeting of the National Conference of Commissioners on Uniform State Laws).

Some states that adopted UDIPTA determined Section 18 authorized combined reporting. *See Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 935 S.W.2d 252 (1996); *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989). Other Courts have determined it does not.⁵⁸ Regardless, the threshold necessary to show that relief should be granted under Section 18 has been debated. The current official comment to Section 18 reads:

Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in Section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

Id. While the comment vests the taxing authority with "broad authority," in practice tax authorities and courts have struggled to define when standard apportionment does not "fairly represent the extent of the taxpayer's business activity in this state." Professor William Pierce, a drafter of UDIPTA, commented that Section 18

⁵⁸ *See, e.g., Cook v. Dep't of Revenue*, 23 Or. Tax 107, 114 (2018) ("The court is of the opinion that, notwithstanding some imprecise language in discussions of courts over the years, combined reporting is a concept and process separate and distinct from that of apportionment. Apportionment is the process by which a 'base' of business income is divided among two or more states. . . . However, apportionment of a 'base' is separate from determination of the 'base.'"); *Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888, 895 (Ind. T.C. 2015) ("Accordingly, the plain language of Indiana Code § 6-3-2-2(1), like that of Section 18 of UDITPA, 'deals only with the question of the fairness of the [allocation or apportionment] of income, not with the determination of the tax base itself.'"); *Joslin Dry Goods Co. v. Dolan*, 200 Colo. 291, 295, 615 P.2d 16, 18 (1980) ("Section 39-22-303(5) provides that the department may distribute or allocate income and deductions, or may require returns on a consolidated basis. We conclude that it is that statutory provision for distribution and allocation of income and deductions which authorizes the department to require combined reports since a combined report does allocate or apportion income.").

necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.

Twentieth Century-Fox Film Corp. v. Dep't of Revenue, 299 Or. 220, 227, 700 P.2d 1035, 1039 (1985) (quoting William Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (1957)).

Corporate Taxation in South Carolina

South Carolina imposes an income tax of 5% on the “South Carolina taxable income” of every corporation doing business or having income in this state. S.C. Code Ann. § 12-6-530 (2014). “South Carolina taxable income” is computed under the Internal Revenue Code (federal taxable income) “with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter.”⁵⁹ S.C. Code Ann. § 12-6-580 (2014).

If, like CarMax East, a taxpayer conducts business partly within and partly without South Carolina, then “the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State.” S.C. Code Ann. § 12-6-2210(B) (2014). Additionally, if a taxpayer’s principal business in South Carolina is “selling, distributing, or dealing in tangible personal property,” then it “shall make returns and pay annually an income tax that includes its income apportioned to this State.” S.C. Code Ann. § 12-6-2252(A) (2014). CarMax East is a retailer principally engaged in selling tangible personal property in this state, therefore, subsection 12-6-2252(A) applies.

⁵⁹ The starting point for computing any corporate tax in South Carolina—under separate reporting or CUR—is federal taxable income. I will use “federal taxable income” to refer to the starting point in a tax calculation. Sometimes, the starting point is referred to the tax “base.” However, since subsection 12-6-2210(B) of the South Carolina Code (2014) refers to imposing our income tax upon a “base which reasonably represents the proportion of the trade or business carried on within this state,” then “base” means the amount of tax against which the 5% corporate tax is applied after modifications and allocation and apportionment. Accordingly, I do not refer to the starting point as the “base.”

A taxpayer's "income apportioned to this State is determined by multiplying the net income remaining after allocation . . . by the sales factor defined in Section 12-6-2280." § 12-6-2252(A). Pursuant to subsection 12-6-2280(A), "[t]he sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year." S.C. Code Ann. § 12-6-2280(A) (2014). This statutorily defined method of multiplying a taxpayer's South Carolina net income by the sales factor is known as "standard apportionment."

When standard allocation and apportionment does not "fairly represent the extent of the taxpayer's business activity in the state, the taxpayer may petition for, **or the department may require**, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
- (4) **the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.**"

S.C. Code Ann. § 12-6-2320(A) (2014) (emphasis added).

Here, the Department determined that standard apportionment did not fairly reflect Petitioner's business activity in South Carolina. *See id.* Therefore, pursuant to its authority under subsection 12-6-2320(A), the Department required Petitioner to employ another method—CUR. Petitioner contests the Department's interpretation and application of subsection 12-6-2320(A).

Subsection 12-6-2320(A)(4) Authorizes the Application of CUR

Petitioner argues the plain language of subsection 12-6-2320(A)(4) does not authorize the Department to require CUR because subsection 12-6-2320(A)(4) only authorizes an alternative **allocation or apportionment** method, not an alternative **reporting** method, like CUR. I conclude subsection 12-6-2320(A)(4) authorizes the Department to impose CUR.

Reporting Methods

Two reporting methods are at issue in this case: separate reporting and combined unitary reporting (CUR). South Carolina is a separate reporting state. Thus, unless otherwise provided, each corporation with a nexus to South Carolina files a separate tax return even if they are part of a "unitary business." *See* S.C. Code Ann. § 12-6-4910(2) (2014) ("Income tax returns must be

filed by the following: . . . (2) a corporation subject to tax under this chapter.”); S.C. Code Ann. § 12-6-530 (2014) (Imposing an income tax on every corporation “transacting, conducting, or doing business within this State of having income within this State”). Because each corporation in a unitary business files a separate tax return, the federal taxable income of the individual corporation is the starting point for calculating South Carolina income tax. § 12-6-580 (“South Carolina taxable income” is “computed . . . under the Internal Revenue Code with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter.”).⁶⁰

In contrast, when CUR is applied, the federal taxable income of the entire unitary group is the starting point for calculating South Carolina income tax. The federal taxable income for the unitary group is then modified and subject to allocation and apportionment. Moreover, because the unitary group’s federal taxable income is the starting point, the apportionment factor must be altered to adjust for the additional group income. This adjustment does not necessarily change the basic formula of the apportionment factor; rather, it changes what is included in the apportionment factor. For example, in South Carolina, when CUR is imposed, the sales factor remains a ratio of South Carolina sales divided by sales everywhere else. However, instead of the single taxpayer dividing their South Carolina sales by their sales everywhere else, the taxpayer divides the unitary group’s South Carolina sales by the unitary group’s sales everywhere.

Thus, the reporting method affects the calculation of South Carolina income in a couple ways. First, it affects whether the tax calculation starts with a single entity’s federal taxable income or the unitary group’s federal taxable income. Second, the reporting method also affects how the apportionment factor is calculated. The question presented in this case is whether subsection 12-6-2320(A)(4) of the South Carolina Code authorizes the Department to deviate from separate reporting to require CUR under certain circumstances.

⁶⁰ Section 12-6-5020 of the South Carolina Code (2014) provides an exception to separate entity reporting; it allows certain related corporations to file a single tax return called a consolidated income tax return. However, a consolidated return is not the equivalent of CUR. A consolidated return taxes the income of the consolidated entities, whereas CUR merely uses the group’s net income to better calculate the tax upon a single taxpayer within the group, not the consolidated group as a whole. Additionally, only corporations that are subject to tax in South Carolina are allowed to be included in the consolidated return, and each corporation in the consolidated return must separately determine its South Carolina taxable income or loss. § 12-6-5020(B)-(D).

Interpretation of Subsection 12-6-2320(A)(4)

Although the reporting method can affect the apportionment factor, because it also affects the starting point of federal taxable income, Petitioner contends a change to the reporting method is not authorized under the plain language of subsection 12-6-2320(A)(4). Petitioner claims subsection 12-6-2320(A)(4) only authorizes the Department to adjust the “method of allocation and apportionment,” not the amount of federal taxable income from which the tax calculation starts.

In support of its argument, Petitioner cites to *Columbia Sportswear USA Corp. v. Indiana Department of State Revenue*, 45 N.E.3d 888 (Ind. Tax Ct. 2015) (*Columbia Sportswear*). In this case, the Indiana Tax Court had to determine whether Indiana’s alternative apportionment statute (which was modeled after Section 18 of UDITPA, like South Carolina’s) allowed the state’s taxing agency to change the base income (federal taxable income) prior to apportioning such income. *See id.* at 892-94. The Indiana Tax Court held that allowing the taxing agency to adjust the base income, in addition to adjusting allocation and apportionment, would be like trying to pound a square peg into a round hole, and it was contrary to the plain legislative intent of the alternative apportionment statute. *See id.* at 896. Petitioner contends Indiana’s alternative apportionment statute and tax system are the same as South Carolina’s; therefore, this Court should, like the Indiana Tax Court, find South Carolina’s alternative apportionment statute does not authorize the Department to alter federal taxable income.

Obviously, this Court is not bound by the decision of another state. Moreover, other states have interpreted the alternative apportionment statute differently than Indiana, including South Carolina. *See, e.g., Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 935 S.W.2d 252 (1996); *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989). In *Media General Communications, Inc. v. South Carolina Department of Revenue (Media General)*, the South Carolina Supreme Court held subsection 12-6-2320(A)(4) authorized the Department to apply CUR. 388 S.C. 138, 146, 694 S.E.2d 525, 529 (2010). Thus, *Media General* stands for the principle that subsection 12-6-2320(A)(4) is broad enough to encompass an adjustment to the reporting method.⁶¹ In other words, the court concluded a change to the reporting method fell under the umbrella of apportionment.

⁶¹ Petitioner argues this Court should engage in statutory construction of subsection 12-6-2320(A)(4) to resolve this case. However, courts usually engage in statutory construction to interpret a statute when it has not previously

Petitioner disputes this interpretation of *Media General*, arguing our supreme court did not hold subsection 12-6-2320(A)(4) authorizes CUR. Instead, Petitioner claims that imprecise language in the ALC’s underlying decision in *Media General* led the supreme court to approve a **different method of apportionment**, not CUR. Moreover, Petitioner asserts the method approved by the supreme court was not the method advocated or intended by the parties or the ALC.

Regarding “imprecise language,” the *Media General* opinion includes a quotation about “combined entity apportionment”⁶² from the ALC’s underlying order that is slightly misleading:

To determine the tax of a related entity or related entities of a multistate corporation in South Carolina by using the combined entity apportionment method, the individual entity or all related entities (if more than one taxpayer is transacting business in this state), must determine a ratio to apply against its/their taxable income to arrive at its/their net taxable income in South Carolina. The ratio is determined by dividing the gross receipts of all the related entities of the multistate corporation in South Carolina or all the related entities['] property, payroll, and sales from within South Carolina, by all the related entities['] gross receipts from everywhere or the related entities['] property, payroll, and sales from everywhere. **The taxpayer (individual entity) then applies this ratio to the entity’s taxable income in South Carolina to determine its net taxable income.** The corporate tax rate (5%) is then applied to ascertain the tax owed this State.

Media General, 388 S.C. at 146–47, 694 S.E.2d at 529 (emphasis added). Clearly, the bolded language is not as precise as it could be. When viewed in isolation, specification of “the taxpayer (individual entity)” and “the entity’s taxable income” in the bolded section could arguably lead Petitioner to conclude that a combined sales factor (group’s South Carolina sales/group’s sales everywhere) is applied against the single taxpayer’s federal taxable income instead of against the group’s federal taxable income. *Id.* This conflation would result in an absurd interpretation because it would mix separate reporting with combined reporting. However, when this quote is

been interpreted and/or its meaning becomes unclear in a particular application. See *Hodges v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000) (“The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature.”); *Eagle Container Co., LLC v. Cnty. of Newberry*, 379 S.C. 564, 570, 666 S.E.2d 892, 895 (2008) (“We proceed from the familiar premise that in the area of statutory construction, our role is limited to determining legislative intent and effectuating that intent.”). In this case, the South Carolina Supreme Court has already interpreted the meaning of subsection 12-6-2320(A)(4) within the context of whether combined unitary reporting is authorized under that subsection. Therefore, this Court does not need to engage in statutory construction.

⁶² In *Media General*, both the underlying ALC order and the South Carolina Supreme Court referred to combined unitary reporting (or simply combined reporting) as “combined entity apportionment,” which appears to be a linguistic combination of “combined reporting,” “separate entity reporting,” and “apportionment.”

reviewed in the context of the ALC's original order from which it came, it becomes unquestionably clear that the combined sales factor is applied against the group's federal taxable income, consistent with CUR:

- “The term ‘combined apportionment methodology’ means the following when used herein: an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income attributable to activities in South Carolina by taking a portion of the **combined net income of the group** through the utilization of **combined apportionment factors**.”
- “The purpose of the combined apportionment methodology is to determine the income or other tax base of the in-state taxpayer by viewing the taxpayer as part of the unitary business, and applying the apportionment factors of the entire unitary business **to the taxable net income of the unitary business** and 2) to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise.”
- “A state could select the combined report method [combined apportionment method] whereby the **entire net incomes of several commonly owned unitary corporations . . . are included in the taxpayer's apportionable unitary net income base**. . . . Any of these methods are permitted.”

See Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep't of Revenue, Docket No. 07-ALJ-17-0089-CC, and *Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC, at 12-13, 28 (emphasis added). Indeed, a complete reading of the ALC's opinion leaves no doubt that when the ALC discussed “combined entity apportionment,” it was referring to CUR and the two linguistic formulations of this “method” are interchangeable.

Nevertheless, Petitioner argues the supreme court did not approve the method discussed in the ALC's underlying order; rather, it approved a new method that only altered apportionment and did not alter federal taxable income (thus mixing combined reporting with separate reporting). However, the supreme court affirmed the ALC's order **without modification**. Therefore, the supreme court intended to uphold the method approved by the ALC, which was CUR, even though it was called “combined entity apportionment” in the opinion.

Furthermore, the supreme court's own description of “combined entity apportionment” confirms, consistent with CUR, that the group's federal taxable income was utilized rather than the federal taxable income of the single taxpayer:

[Separate entity apportionment] is in contrast to the combined entity apportionment method, which the parties have stipulated is defined for this matter as an accounting method whereby each member of a group carrying on a unitary

business computes its individual taxable income attributable to activities in South Carolina by taking **a portion of the combined net income of the group** through the utilization of combined apportionment factors. **The combined income of the unitary group is not computed for the purpose of taxing such income**, but rather **as a basis** for determining **the portion of income from the entire unitary business attributable to sources within South Carolina that is derived by members of the group subject to South Carolina's taxing jurisdiction**. One of the purposes of this method is to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise.

Media General, 388 S.C. at 142, 694 S.E.2d at 527 (emphasis added). The bolded portions of this quote from *Media General* show the supreme court interpreted combined entity apportionment to utilize the “combined income of the unitary group,” aka the group’s federal taxable income, as a starting point against which the combined sales factor was applied. *Id.* This describes CUR.

To the extent Petitioner asks this Court to deviate from the supreme court’s interpretation, our supreme court’s decision in *Media General* is a fair and reasonable interpretation of our statutory scheme, even if another state, like Indiana, interprets a similar scheme differently. *Compare Media General*, 388 S.C. 138, 146, 694 S.E.2d 525, 529, with *Columbia Sportswear*, 45 N.E.3d 888; *see also McLeod v. Starnes*, 396 S.C. 647, 655, 723 S.E.2d 198, 203 (2012) (“Stare decisis applies with full force with respect to questions of statutory interpretation because the legislature is free to correct us if we misinterpret its words.”). In fact, it makes sense that CUR would fall under the umbrella of apportionment in subsection 12-6-2320(A) because it ultimately seeks to more fairly apportion the income of unitary taxpayers among taxing jurisdictions.

Additionally, subsection 12-6-2320(A) provides for the use of alternative methods of allocation and apportionment, “[i]f the allocation and apportionment provisions **of this chapter** do not fairly represent the extent of the taxpayer’s business activity in this State.” (emphasis added). Thus, this subsection must be read within the context of Chapter 6 of Title 12 (governing allocation and apportionment). *See TNS Mills, Inc. v. S.C. Dept. of Revenue*, 331 S.C. 611, 503 S.E.2d 471 (1998) (“In construing statutory language, the statute must be read as a whole, and sections which are part of the same general statutory law must be construed together and each one given effect.”). One provision of importance in Chapter 6 is subsection 12-6-2210(B), which instructs that “[i]f a taxpayer is transacting or conducting business partly within and partly

without this State, the South Carolina income tax is imposed upon a **base which reasonably represents the proportion of the trade or business carried on within this State.**” (emphasis added). According to the Department’s evaluation of Petitioner’s tax returns during the audit period, the South Carolina income tax was imposed upon a base (CarMax East’s federal taxable income) that did not “reasonably represent the proportion of the trade or business carried on within this State,” contrary to subsection 12-6-2210(B). *See Duke Energy Corp. v. S.C. Dep’t of Revenue*, 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016) (holding the primary thrust of South Carolina’s apportionment statutes is “to apportion to South Carolina a fraction of the taxpayer’s total income reasonably attributable to its business activity in this State”).

Therefore, while an isolated reading of the section quoted from the ALC’s order in *Media General* may lead one to infer that “combined entity apportionment” only impacts the calculation of the apportionment (sales) factor under section 12-6-2280, that inference would be incorrect—combined entity apportionment is the same as CUR, which affects the federal taxable income starting point and the apportionment factor. Moreover, our supreme court’s decision is reasonable under South Carolina’s statutory scheme. *See* § 12-6-2320(A); § 12-6-2210(B).

The Department Met Its Burden

In cases where the Department asserts an alternative apportionment method under subsection 12-6-2320(A)(4), our supreme court has held the Department bears the burden of proof. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep’t of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014); *Rent-A-Ctr. W. Inc. v. S.C. Dep’t of Revenue*, 418 S.C. 320, 792 S.E.2d 260 (Ct. App. 2016). To meet its burden, the Department must prove: (1) that the statutory formula does not fairly represent CarMax East’s business activity in South Carolina and (2) that the proposed alternative formula is reasonable and equitable. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200.

CarMax East’s Business Activity is Not Fairly Represented

Subsection 12-6-2320(A) requires the Department to show the extent of CarMax East’s “business activity” in South Carolina is not fairly represented by standard allocation and apportionment.

Business Activity

“Business activity” is not defined for the purposes of subsection 12-6-2320(A). However, from a factual perspective, CarMax East’s business activity in South Carolina is clear. CarMax

East's business activity during the audit period was selling and purchasing cars and selling EPPs. Additionally, CBS's South Carolina business activity in South Carolina was reported on CarMax East's and CarMax's West's South Carolina tax returns. Thus, CarMax East also reported CBS's South Carolina business activity on its tax return, to include licensing income from IP utilized in South Carolina and finance income from loans that originated in South Carolina.⁶³ And, while in some cases income may not reflect business activity, here, where all of CarMax East's business activity results in revenue, I find that income is a proxy for CarMax East's business activity in this state.⁶⁴

Type of Evidence Sufficient to Show Unfair Representation

Next, in *Carmax* and *Rent-A-Center*, our courts have discussed the type of evidence that is sufficient, or insufficient, to show whether business activity is fairly represented. *See Carmax*, 411 S.C. at 90–91, 767 S.E.2d at 201; *Rent-A-Center*, 418 S.C. at 333, 792 S.E.2d at 267. Additionally, in Revenue Ruling #15-5, the Department has provided guidance about how it determines whether business activity is fairly represented under subsection 12-6-2320(A)(4).

In *Carmax*, the South Carolina Supreme Court held the evidence offered by the Department was insufficient to meet its burden to show the statutory formula did not fairly represent CarMax West's business activity in South Carolina. 411 S.C. 79, 90–91, 767 S.E.2d 195, 201 (2014). The court cited the following evidence as insufficient: (1) testimony from the Department's auditor that the "business structure of CarMax West and CBS is often 'linked with tax minimization strategies,'" (2) "the fact that CarMax West's apportionment ratio yielded a significantly lower tax than that of CarMax East" in support of the Department's "determination that CarMax West's income was diluted," and (3) "bald assertions by [the Department's] witnesses that it satisfied this threshold question." *Id.* at 90-91, 767 S.E.2d at 201.

The South Carolina Court of Appeals likewise found the Department failed to meet its burden in *Rent-A-Center West Inc. v. South Carolina Department of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016). The court of appeals rejected the following Department

⁶³ CarMax West also paid tax in South Carolina based upon the pass-through income it received from CBS related to licensing and finance income sourced to South Carolina.

⁶⁴ *Cf. Twentieth Century-Fox Film Corp.*, 299 Or. at 233–34, 700 P.2d at 1042–43 (1985) ("It is also important to note that it must be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state.").

testimony because it was insufficient to show the statutory formula did not fairly represent Rent-A-Center's business activity in South Carolina: (1) Rent-A-Center was comprised of multiple entities and the Department auditor believed a management services fee was too high and (2) the Department's expert indicated that excluding the retail operations from the calculations was essential to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina" and "using the standard apportionment method would be like having apples in the numerator, while having apples and oranges in the denominator." *Id.* The court of appeals specifically noted that the Department's auditor "did not point to any specific evidence the standard apportionment method did not fairly represent RAC West's business activities." *Id.*

Based upon these two cases, it is clear the Department must provide specific evidence supporting its assertion that standard allocation and apportionment does not fairly reflect CarMax East's business activity in South Carolina. *See Carmax Auto Superstores W. Coast, Inc.*, 411 S.C. at 90-91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. In other words, the Department cannot rely on business characteristics or business structures that "may" indicate a tax minimization scheme, bald assertions of unfairness or distortion, or a contention that standard allocation and apportionment results in less tax to this state. *See id.*

Next, in Revenue Ruling #15-5, the Department outlined "[s]ome of the facts" it may consider when determining if the standard allocation and apportionment fairly represents the extent of a taxpayer's business in South Carolina. Revenue Ruling #15-5 at 6. Those facts include:

- (1) amounts paid to related parties for good and services or goods and services provided without payment;
- (2) profit margins associated with business activities;
- (3) capital investments associated with business activities;
- (4) whether goods and services are provided to both related and unrelated parties on similar terms;
- (5) whether taxpayers in similar industries provide similar good and services to unrelated parties under similar terms; and
- (6) whether the taxpayer would be willing to enter into a similar arrangement with an unrelated third party considering, among other issues, the relinquishment of control over the business activity.

Revenue Ruling #15-5 at 6-7.

Revenue Ruling #15-5 also states that a Section 482 transfer pricing study supporting prices between related entities “is not determinative of whether South Carolina’s statutory apportionment formula fairly represents the taxpayer’s business activities in South Carolina.” *Id.* at 7. It further states that the Department has required or approved CUR “in situations involving the use of purchasing companies, management fee companies, and ‘east/west’ companies within a unitary group.” *Id.* at 7 (footnotes omitted). Revenue Ruling #15-5 defines a “management fee company” as “a member of the unitary business group that provides general management services to related operating companies for a fee.” *Id.* at 7 n.14. “East/west companies” are defined as:

generally members of a unitary business divided into two corporations. The west company is located in a state where combined unitary reporting including both the west and east company is required. The east company is located in a state where separate entity reporting is required. The east company pays the west company for the use of intangibles, management fees, or other services generating an expense for the east company. The west company’s income is not increased by these payments since the west company is already filing a combined unitary report that includes the east company.

Id. at 7 n.15.

Not Fairly Represented by Standard Allocation and Apportionment

I conclude the Department showed by a preponderance of the evidence that the extent of CarMax East’s business activity in South Carolina is not fairly represented by standard allocation and apportionment. *See* § 12-6-2320(A)(4) (providing the Department may require another method when standard allocation and apportionment do not “fairly represent the extent of the taxpayer’s business activity in the state”). Specifically, the evidence established that CarMax East shifted a significant amount of its taxable income to CarMax West through the Management Fee and the CBS partnership. As a result of the income shifting, CarMax East’s federal taxable income and its South Carolina taxable income was significantly and unjustifiably reduced. This reduction does not fairly reflect the extent of CarMax East’s business activity in South Carolina, for which income is a proxy. Moreover, separate reporting and standard allocation and apportionment do not correct for this unjustified reduction; rather, they create a safe harbor for it.

The Management Fee and East-West Structure Distorted CarMax East's Business Activity

In requiring CUR, the Department relied, in part, on the presence of a management fee and an east-west structure. The mere existence of a management fee and an east-west structure do not necessarily merit the imposition of CUR. A management fee, when appropriately priced to mimic uncontrolled transactions, should be respected. Similarly, an east-west structure is not illegal. In other words, the company's structure, alone, should not merit the imposition of CUR. In this case, however, the evidence established the Management Fee and the partnership distributions work together to shift a substantial amount of income from CarMax East to CarMax West, in an east-west structure, for no discernable business reason other than tax minimization.⁶⁵

At trial, the Department did not rely on the mere existence of a management fee. The Department showed that the Management Fee was not reliable under the 482 Regulations and appeared to be too high. But, because neither party produced a reliable arm's length range for comparison, I cannot find the Management Fee, on its own, distorted CarMax East's business activity such that it was not fairly represented by standard allocation and apportionment.

Nevertheless, the Management Fee was integral to CarMax's overall scheme to shift money from CarMax East to CarMax West because the initial shift of money away from CarMax East, and to CBS, was accomplished through the Management Fee. That initial shift to CBS allowed the partnership to then siphon money to CarMax West through the partnership distributions. Thus, even if the Management Fee charged during the audit years was an arm's length fee, the partnership distributions shifted a substantial amount of the income CBS earned from the Management Fees disproportionately back to CarMax West, in an east-west structure. Through these intercompany transactions, CarMax East reduced its federal taxable income by \$1.6 billion for the audit period while CarMax West increased its federal taxable income by \$1.4 billion.

More specifically, CarMax East generated about 75% of the Group's revenues and, likewise, contributed about 75% of the income CBS earned from its Management Fees. However, CarMax East was only attributed with about 20% of the Group's taxable income because the rest

⁶⁵ In making this finding, the Court is not concluding that the formation of CBS had no purpose except tax minimization; rather, this finding is narrowly tailored to how CBS shifts money from CarMax East to CarMax West.

of its revenue, which would have become taxable income, was shifted to CarMax West through CarMax West's 93.5% interest in the partnership.⁶⁶

Conversely, because CarMax West received 93.5% of CBS's income, although it only produced 25% of the Group's revenues and 25% of CBS's Management Fees, it was attributed with about 80% of CarMax's taxable income. Stated differently, although CarMax West produced 33% of the income CarMax East produced, CarMax West's income produced 541% more federal taxable income than CarMax East because of how the management fee and partnership siphon income from CarMax East to CarMax West.

As these percentages show, the partnership distributions distorted CarMax East's taxable income.⁶⁷ The distortive effect of the partnership on South Carolina tax is also significant. Dr. DeRamus explained that over the course of the three audit years, CarMax East's South Carolina stores had a total operating profit of approximately \$90,000,000; however, their taxable income apportioned to South Carolina was only approximately \$21,000,000. The difference in those values reflects the movement of income from CarMax East to CBS through the Management Fee, and then the flow through of the vast majority of CBS's income back to CarMax West under the partnership's terms.

Thus, regardless of whether the underlying partnership distributions are proper or not, the Department showed that their effect is to distort CarMax East's taxable income in this state.⁶⁸ Petitioner repeatedly argued that because the partnership distributions were set in 2004, they are

⁶⁶ Stated differently, CarMax East had a net taxable income return of \$10.54 for every \$100 of income it produced while CarMax West had a net taxable income return of \$57.00 for every \$100 of income it produced. Petitioner complains that these "distortion ratios" do not help the Department meet its burden and are not published, thus failing to provide taxpayers with notice that they will be used. The Department is not required to publish notice of every mathematical calculation it might possibly make to show that a certain method does not fairly reflect business activity within this state. Companies and their structures are unique—where one mathematical ratio illuminates an aspect of one company, it may not do so for another. Under the facts of this case, I find the "distortion ratios" used by the Department demonstrate that income is not flowing between the companies in the manner one would expect, which signals distortion if not otherwise justified. For instance, because CarMax East and CarMax West are in the same business with similar expenditures and costs, their ratios should be similar as well.

⁶⁷ Petitioner complains the Department used the sales percentages to improperly apply something called the "matching principle." Under the matching principle, the Department contended the money flowing back to CarMax East and CarMax West through the partnership should be in proportion to how much each company contributed to CBS's earnings through the Management Fees they paid. While the Department may have relied, in part, on this principle, the Court does not. Nevertheless, the discrepancy between how much income CarMax East earns and how much taxable income it produces is evidence of distortion in this case.

⁶⁸ This effect is exacerbated to the extent that the transfer prices under the MMSA are inflated and siphon more income to CBS than is appropriate.

beyond this Court's scope of review, and they are irrelevant to this case. Petitioner further asserts in its proposed order that

[e]ven if the 2004 Valuation Study was egregiously incorrect as DeRamus suggested, CarMax East still owned 6.5% of CBS during the Audit Period, and the issue before the Court would still be whether CarMax East's tax returns during the Audit Period fairly reflect (1) the South Carolina business activity of CarMax East during the Audit Period, plus (2) 6.5% of the South Carolina business activity of CBS during the Audit Period.

Petitioner makes no legal argument why the Court should simply respect partnership distributions without further inquiry. Petitioner merely asks the Court to find them irrelevant.

Based upon the evidence presented to this Court, the operation of the partnership percentages is extremely relevant to this case. Petitioner's reluctance to address this topic only operates to its detriment.⁶⁹ In sum, based on the evidence before the Court, the shift in income from CarMax East to CarMax West does not fairly represent the extent of CarMax East's business activity in the state during the audit period.

Separate Reporting and Standard Allocation and Apportionment Provided a Safe Harbor

While it may be true that the legislature intended for separate reporting to provide an advantageous tax environment, it cannot be true that the legislature intended to provide a safe harbor for intercompany transactions that distort a company's business activity in this state such that its business activity is not fairly represented for tax purposes. Here, CarMax's intercompany transactions artificially and significantly reduce CarMax East's taxable income. Yet, because separate reporting and standard allocation and apportionment respect intercompany transactions, they do not correct for this issue. Rather, they shelter intercompany transactions that abuse the state's tax scheme.

In this case, standard allocation and apportionment produces a sales factor that is based upon CarMax East's sales in South Carolina divided by its sales everywhere. Normally, this ratio is a perfectly rational way to apportion income to a taxpayer.⁷⁰ However, because of the income

⁶⁹ Once the Department met its burden that CarMax East's business activity was not fairly represented, the burden switched to Petitioner to show why the Department was incorrect. *See Daisy Outdoor Adver. Co., Inc. v. S.C. Dep't of Transp.*, 352 S.C. 113, 118, 572 S.E.2d 462, 465 (Ct. App. 2002) ("Once a party establishes a prima facie case, the burden of proof shifts to the opposing party.").

⁷⁰ Petitioner repeatedly argues that the sales factor measures "business activity" under section 12-6-2320, and because this ratio was correct during the audit years, the Department cannot show that CarMax East's business

shifting in this case, this ratio is applied against a federal taxable income that is artificially reduced because separate reporting respects this artificial reduction without question. As a result, standard apportionment does not produce a result that fairly represents the business activity; it produces an artificially lowered amount of taxable income that does not represent business activity because the ratio is applied against a smaller amount of taxable income than it should be.

More specifically, CarMax East's South Carolina stores had a total operating profit of approximately \$90,000,000; however, their taxable income apportioned to South Carolina was only approximately \$21,000,000. Thus, by shifting income from CarMax East to CarMax West through the Management Fee and the partnership distributions, the starting point (federal taxable income) for calculating South Carolina's income tax is significantly reduced, and for no reasonable purpose relating to business activity. Further, by artificially lowering CarMax East's federal taxable income, South Carolina's apportionment factor is applied against a much smaller starting number that then produces a significantly lower amount of tax that does not fairly represent the amount of business activity that takes place in the state. Moreover, because CarMax West is only taxed in South Carolina on its receipts from IP and financing, the portion of CarMax East's income from its retail sales that is shifted to CarMax West effectively escapes any calculation of taxation in South Carolina. Separate reporting, including standard allocation and apportionment, cannot capture this significant, unsupported re-routing of income from one taxpayer to another in a separate jurisdiction because separate reporting respects the taxpayer's corporate structure and the taxpayer's federal taxable income that results from that structure.

Since I find the extent of CarMax East's business activity in South Carolina is not fairly represented by standard allocation and apportionment under separate reporting, I now turn to whether the Department's imposition of CUR was reasonable and equitable.

Reasonable and Equitable

I conclude the Department met the second part of its burden, which is to show the application of CUR would be reasonable and equitable.

Pursuant to subsection 12-6-2320(A), "the department may require, in respect to all or any part of the taxpayer's business activity, if **reasonable** . . . (4) the employment of any other

activity was not fairly represented. However, because of the artificial reduction in federal taxable income, the sales factor does not produce a fair representation of CarMax East's income.

method to effectuate an **equitable** allocation and apportionment of the taxpayer's income." § 12-6-2320(A)(4) (emphasis added). *See Carmax*, 411 S.C. at 89, 767 S.E.2d at 200 (holding "the proponent of the alternate formula bears the burden of proving by a preponderance of the evidence that . . . its alternative accounting method is reasonable").

The definitions of "reasonable" and "equitable" are very similar. Generally, "reasonable" means "fair, proper, or moderate under the circumstance," while "equitable" means "just; consistent with principles of justice and right." *See Reasonable*, BLACK'S LAW DICTIONARY (11th ed. 2019); *see also Equitable*, BLACK'S LAW DICTIONARY (11th ed. 2019). Similarly, Merriam-Webster defines "equitable" as "dealing fairly and equally with all concerned" and "reasonable" as "moderate, fair." *See* <http://www.merriam-webster.com/dictionary/equitable> (last visited on July 11, 2024); *see also* <http://www.merriam-webster.com/dictionary/reasonable> (last visited on July 11, 2024).

In addition to these definitions, in Revenue Ruling #15-5, the Department set forth two criteria that it uses to evaluate reasonableness: (1) the division of income must fairly represent the taxpayer's business activity in this State and, if applied uniformly, would result in taxation of no more or no less than 100% of the taxpayer's income; and (2) the division of income must reflect the economic reality of the business activity engaged in by the taxpayer in this State.⁷¹ I find that these criteria are a legally sound method of assessing reasonableness and equity under the facts of this case.

In making this determination, I recognize that it is not reasonable to require CUR simply because a business is a unitary business. *See, e.g., Rent-A-Ctr. E., Inc. v. Indiana Dep't of State Revenue*, 42 N.E.3d 1043, 1048 (Ind. T.C. 2015) ("Regardless of a possibility of distortion, however, Indiana's AGIT statutory framework does not require a member of a unitary group to file a combined income tax return solely because there is a unitary relationship."). It is also not reasonable to impose combined unitary reporting merely because it will result in more tax than separate entity reporting. *See Carmax*, 411 S.C. at 91, 767 S.E.2d at 201 *citing with approval St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 212, 385 A.2d 215, 217 (1978) ("Merely because the use of an alternative form of computation produces a higher business activity attributable to

⁷¹ These criteria were based upon the Oregon Supreme Court's three-part test for "reasonableness" in *Twentieth Century-Fox Film Corporation v. Department of Revenue*, 299 Or. 220, 700 P.2d 1035 (1985). Although the Oregon Supreme Court set forth three criteria, the Department correctly observed that the second element of the Oregon Supreme Court's test only applies to UDIPTA jurisdiction, which South Carolina is not.

New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.”).

Requiring CUR is Reasonable and Equitable

Applying subsection 12-6-2320(A) and this guidance, I find requiring CUR is reasonable because it corrects the shift in income that distorts CarMax East’s federal taxable income while retaining a reasonable and equitable allocation and apportionment of CarMax East’s income to this state. Specifically, under CUR, the starting point of calculating South Carolina taxable income is the federal taxable income of the entire unitary group. As a result, the income that was shifted from CarMax East to CarMax West to artificially reduce CarMax East’s federal taxable income is returned and the distortive effect of Management Fee and partnership distributions is eliminated. Then, because CUR starts with the Group’s federal taxable income, CUR also alters the sales factor to reflect the Group’s South Carolina sales divided by the Group’s sales everywhere. In this particular case, the changes to the sales factor resulted in a smaller sales factor ratio. Thus, under CUR, the starting point of federal taxable income was bigger, but the sales factor ratio was smaller to retain proper proportions of what is being measured (apples to apples). Because federal taxable income is in proportion to the combined sales factor, the result of CUR is a taxable base for the Group reasonably attributed to South Carolina income from retail sales, licensing, and finance income (business activity). When this process is applied uniformly, it does not result in taxation of more or less than 100% of the taxpayer’s income. *See Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43.

Next, because the use of CUR resulted in a taxable income for the group, in this case, the Department credited CarMax East with the taxes already paid by CarMax West during the audit years. The resulting assessment corrected for the artificial reduction of CarMax East’s federal taxable income by eliminating the intercompany shifting of income. As a result, CUR produced a taxable income apportioned to CarMax East that better reflects the economic reality of CarMax East’s business activity in this state. *See Revenue Ruling #15-5; Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43. In contrast, under separate reporting and standard apportionment, the economic reality that CarMax East had around \$90,000,000 in South Carolina sales was distorted by the partnership distributions to reflect only \$21,000,000 worth of taxable business activity.

Gross Over-Correction and Over-Taxation

Petitioner also argues that CUR is unreasonable and a gross over-correction. Petitioner asserts CUR results in CarMax East being severely over-taxed contrary to the guidance in Revenue Ruling #15-5, which directs that CUR should result in taxation of no more or no less than 100% of the taxpayer's income. *See* Revenue Ruling #15-5; *see also Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43. Specifically, Petitioner contends that during the audit period, approximately 3.49% of CarMax East's total business activity took place in South Carolina, yet CUR would impose a tax on approximately 10.86% of CarMax East's total income subject to apportionment.⁷² Petitioner further argues it is patently unreasonable to impose tax on 10.86% of CarMax East's total income subject to apportionment when only 3.49% of CarMax East's total business activity occurred in South Carolina. Moreover, if all states uniformly applied CUR against CarMax East in this manner, the end result would cause CarMax East to pay tax on more than 300% of its income subject to apportionment, not “no more or no less than 100% of the taxpayer's income” as Revenue Ruling #15-5 instructs.

Petitioner's argument relies on its assumption that the Management Fee and partnership distributions do not result in distortion and, therefore, CarMax East's reported federal taxable income is correct and does not need to be adjusted. When the taxable base, as calculated under CUR (the amount subject to the 5% tax), is taken as a percentage of CarMax East's federal taxable income as calculated under separate reporting, then of course it will appear like the Department is taxing an excessive amount of CarMax East's income—you are comparing apples to oranges. Mixing federal taxable income under separate reporting with the taxable base calculated under CUR is going to produce a result that looks like CarMax East is being over-taxed, but the Department did not apply a mixed method like this. Therefore, Petitioner's argument is misplaced.

Targeting CarMax East Instead of CarMax West

Next, Petitioner asserts the Department is making the same arguments it made in *Carmax* in 2014, except the Department is now targeting CarMax East instead of CarMax West. *Carmax*, 411 S.C. 79, 767 S.E.2d 195 (2014). Petitioner essentially complains that this is the same case

⁷² Petitioner asserts CUR resulted in approximately 12.09% of CarMax East's total income being subject to apportionment but after accounting for the credit for taxes paid by CarMax West, that amount was effectively reduced to 10.86%.

against a different, related party, but makes no legal arguments why these facts matter; Petitioner simply argues that allowing the Department to make similar arguments in this case is “neither reasonable nor equitable.”

This case is distinguishable from the prior *Carmax* litigation because, in that case, the Department did not seek to impose CUR like it does here. Rather, it sought to impose a different variation of apportionment under subsection 12-6-2320(A)(4) to prevent CarMax West from diluting its sales factor. *Carmax*, 411 S.C. at 84, 767 S.E.2d at 197. Moreover, CarMax West is a different party that was not treated by the Department as a unitary business in that case, and the Department presented different factual evidence to support its alternative apportionment method. *Id.* at 90, 767 S.E.2d at 201 (finding the Department’s evidence consisted of testimony that CarMax West’s and CBS’s business structure is often “linked with tax minimization strategies” and “CarMax West’s apportionment ratio yielded a significantly lower tax than that of CarMax East”). Therefore, without any legal theories to support its generic assertion that allowing the Department to present a **similar yet distinct** case against CarMax East is “neither reasonable nor equitable,” I find this argument without merit.

Wrong Solution

Finally, Petitioner argues that good tax policy would dictate that CUR cannot be used to correct a problem such as the price of a transaction. Petitioner asserts the Department has Section 482 powers exactly for this purpose—to correct transfer pricing issues without changing the reporting method and applying CUR. The crux of Petitioner’s argument is that if there is a problem with the Management Fee, it should be treated like an improper deduction, and subsection 12-6-2320(A)(4) is the wrong tool to fix that sort of problem. Rather, Petitioner asserts the Department should utilize its 482 powers to correct the transfer price, which would correct the problem while respecting the legislature’s choice to have South Carolina be a separate reporting state.⁷³

⁷³ Since Petitioner does not think this Court should address the partnership distributions at all, it is unclear whether Petitioner would also have the Department utilize its Section 482 power to fix the distorting effect of the partnership distributions. I note that partnership interests can be reallocated for tax purposes under the 482 Regulations. *See* 26 C.F.R. § 1.704-1(b)(1)(iii) (providing that a partnership “allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482”); 26 C.F.R. § 1.704-1 (Example 28); 26 C.F.R. § 1.482-1(a)(2) (“The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations).”).

In theory, the issues in this case can be fixed using the Department’s Section 482 powers while preserving separate reporting. Indeed, because South Carolina is a separate reporting state, this method of reporting should not be lightly disregarded, nor an alternative method of reporting/apportionment be lightly imposed. *See Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep’t of Revenue*, 411 S.C. 79, 89–90, 767 S.E.2d 195, 200 (2014); *citing with approval Donald M. Drake Co. v. Dep’t of Revenue*, 263 Or. 26, 500 P.2d 1041, 1044 (1972) (holding “the use of any method other than apportionment should be exceptional” and the party seeking to use an alternative method bears the burden of proof).

Unfortunately, neither the Department nor CarMax East provided the Court with reasonable, arm’s length calculations of the Management Fee or a way to account for the distorting effect of the partnership distributions. Accordingly, this Court has no sound evidence upon which to correct these issues using separate reporting and the Department’s Section 482 powers. Moreover, even if the Department could have used its Section 482 powers to correct the distortion in this case, the fact remains that under a plain reading of subsection 12-6-2320(A)(4), CarMax East’s business activity was not fairly represented under standard allocation and apportionment during the audit period. Thus, the Department acted within its authority to require an alternate method—CUR—under subsection 12-6-2320(A).⁷⁴ *See Media General*, 388 S.C. at 146, 694 S.E.2d at 529.

Finally, I note that although addressing intercompany issues with Section 482 powers may have allowed separate reporting to remain intact, as this case clearly demonstrates, utilizing Section 482 power is a complicated and fraught venture that takes enormous time and resources to ostensibly arrive at the same result as CUR achieves in this case: a fair representation of the taxable business activity in this state for a single taxpayer.

CONCLUSION

It is clear CarMax was more than benignly taking advantage of a corporate structure and South Carolina’s default reporting method. Indeed, it was using intercompany transfer pricing and a partnership with an east-west structure to significantly distort CarMax East’s business activity in South Carolina and artificially lower its tax burden in South Carolina without

⁷⁴ To clarify further, I do not read subsection 12-6-2320(A) to require that separate reporting and standard allocation and apportionment must **cause** the unfair representation. It is enough that the business activity is unfairly represented when they are applied.

reasonable and reliable justification. Separate reporting, along with standard allocation and apportionment, did not capture or correct this distortion; it shielded it. Under standard allocation and apportionment, the extent of CarMax East's business activity in South Carolina was not fairly represented during the audit period. § 12-6-2320(A). Under subsection 12-6-2320(A), CUR is an authorized alternative apportionment method. *Media General*, 388 S.C. at 146, 694 S.E.2d at 529. In this case, CUR is a reasonable and equitable alternative method that will correct the distortion and result in a fair representation of CarMax East's business activity in this state. Accordingly, I find the Department's determination was correct.

ORDER

IT IS HEREBY ORDERED that the Department's application of an alternative apportionment method is upheld. Petitioner is required to use combined unitary reporting on its South Carolina corporate income tax returns for fiscal years 2016-2018.

AND IT IS SO ORDERED.



Ralph King Anderson, III
Chief Administrative Law Judge

August 15, 2024
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, Stephanie Perez, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).



Stephanie Perez
Judicial Law Clerk

August 15, 2024
Columbia, South Carolina